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ddeakins@tscpa.net
972-687-8550
800-428-0272, ext. 250

TECHNICAL EDITOR
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technicaleditor@tscpa.net

COLUMN EDITOR
Don Carpenter, MSAcc/CPA

WEB EDITOR
Wayne Hardin
whardin@tscpa.net

CONTRIBUTORS
Anice Asberry; Melinda Bentley; Sarah Brown; Bryan Garza; Roxanne LaDu; Craig Nauta; Kari Owen; Josef Rashty

DIRECTOR, MARKETING AND COMMUNICATIONS
Melinda Bentley, CAE

CLASSIFIED
DeLynn Deakins
Texas Society of CPAs
14651 Dallas Parkway, Suite 700
Dallas, Texas 75254-7408
972-687-8550
ddeakins@tscpa.net.

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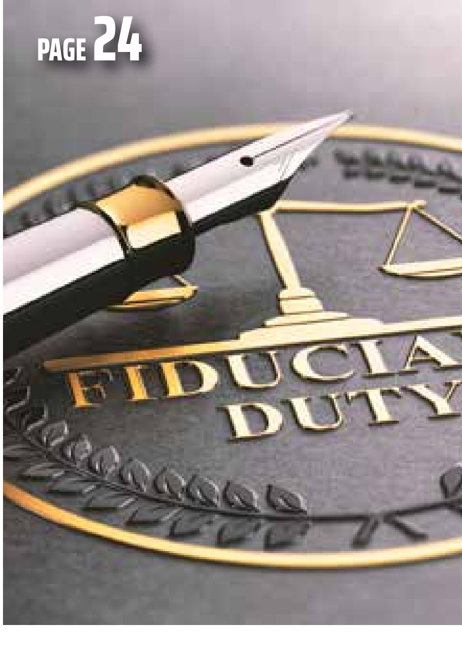

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TXCPA

RESOLVE TO BE INVOLVED!

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! With each new year comes the opportunity to refocus our energy to continue to make a difference and make the most of each day. Some of our new year's resolutions fall by the wayside come February, but with a little help from each other we can stay focused on what we really want to accomplish.

Your membership provides benefits that may help you achieve some of your personal and professional resolutions. All you have to do is resolve to be involved! That doesn't mean you have to be at every meeting or lead a committee, although that level of commitment does reap big benefits. You can be involved without even leaving your hometown!

Here are just a few ways that you can stick to your resolutions with TXCPA involvement.

Helping and mentoring others: Participation in our online forum, TXCPA Exchange, helps expand the value of this benefit to all members. As we ask or answer questions based on our personal experiences, we're all getting better and growing. I know we can each think of a time someone helped us find an answer and saved us valuable time and angst. We can now pay it forward by helping someone else through this valuable benefit.

Learning something new: TXCPA and your chapter provide a host of education programs that help you develop personally and in your career. And with TXCPA's online learning opportunities, you can learn about a new topic whenever and wherever you need to.

Serving in your community: Our chapters offer fantastic service opportunities that will get you out in your community and help show the public how much our profession cares. We get to serve together and learn more about each other as we help those around us.

Growing our amazing profession: TXCPA and your chapter have many opportunities to interact with students of all levels to tell your story about becoming a CPA, the wonderful benefits our career provides and the benefits of being involved in your professional society. This is one of my personal resolutions – to share with students and faculty at every opportunity!

These are just a few ways we can band together to be even better individually and as a profession in 2020! Won't you join me and resolve to be involved? Best wishes for a wonderful and productive year ahead!

RENEWED FOCUS ON AUDITING ACCOUNTING ESTIMATES CALLS FOR COMPANIES TO REEXAMINE ACCOUNTING PROCEDURES

By Don Carpenter, MSAcc/CPA

Two recent developments have moved the use of estimates in financial accounting to the forefront. The AICPA Auditing Standards Board released a Statement of Auditing Standards exposure draft, *Auditing Accounting Estimates and Related Disclosures* and, concurrently, the Public Company Accounting Oversight Board (PCAOB) issued new guidance for auditing accounting estimates for accounting years ending on or after December 15, 2020.

The exposure draft spotlights how extensive the reliance on estimates is for material items in both the financial statements and related disclosures. It lists several areas that auditors should focus on because the reliance on estimates is critical:

- Useful lives and depreciation,
- Outcome of pending litigation,
- Insurance contract liabilities,
- Warranty obligations,
- Employee benefit obligations,
- Share-based payments,
- Impairment of long-lived assets,
- Long-term contracts, and
- Fair value accounting.

In evaluating the process and results that rely on the use of accounting estimates, auditors are directed to consider both the inherent risk factors and the control risk factors that are integral to financial statement integrity. Inherent risk factors include:

- Estimation uncertainty,
- Complexity and
- Subjectivity.

The weighting of these factors will differ in each area where estimation is applicable. For example, estimation uncertainty is not as critical where reliance can be placed on active, open-market transactions as compared to unique one-off value estimations. Likewise, complexity will increase when multiple input estimates are required or when a process requires a number of interrelated steps to complete.

The subjectivity of an estimate will increase as the range of possible results widens due to yet-to-be determined factors and possibilities. The auditor must consider whether inherent risk, complexity and subjectivity are being properly identified and managed, as well

Don Carpenter is clinical professor of accounting at Baylor University. Contact him at Don_Carpenter@baylor.edu.

as adequately discussed in the disclosures accompanying the financial statements.

Distinct from inherent risk, the auditor must assess control risk. This evaluation includes an assessment of the degree to which it is possible to establish controls with regard to the specific estimation process and the extent to which the company is effectively relying on these controls. The assessment should include a consideration of management's evaluation of the appropriateness of the methodology employed to make the estimation. For example, should the process rely on a discounted cash flow model, option pricing or third party comparables?

Further, the auditor should consider the extent to which management is relying on third party or internal subject matter experts and the documentation that supports that reliance. The control assessment should also consider the appropriate segregation of duties, including review and the controls supporting data integrity and computer models.

Of course, all businesses do not have the same degree of reliance on estimates and every business will rely more heavily on estimates in some areas of their financial processes than in others. Organizations may be quite comfortable with the necessity of relying on estimates, but it is clear in these new releases that the auditor must rely on his/her professional judgement to independently assess the areas where reliance is most critical and where material misstatements are most likely to occur. This assessment must also include skeptical evaluation of the potential or actual presence of management bias. For example:

- Has management changed the method of developing an estimate or the source data upon which an estimate is determined?
- Does management have a pattern of selecting a point estimate that consistently indicates optimism or pessimism?

This emphasis on the review of accounting estimates supports PCAOB's AS 3101 that requires the auditor's report to include a discussion of critical audit matters, such as the use of estimates to measure financial statement results. (See "Auditor's Report is Scheduled for Remodeling" in the January/February 2019 issue of *Today's CPA*.)

COMMUNICATION BETWEEN THE CLIENT'S ACCOUNTING TEAM AND THE AUDITOR BECOME EVEN MORE IMPORTANT.

Communication between the client's accounting team and the auditor become even more important. It's critical that there is a clear understanding of the areas where accounting estimates are relied on and the extent to which documentation will be required to help the auditor reach an independent decision regarding the appropriateness of the reliance.

In anticipation of this renewed emphasis on accounting estimates by auditors, companies would be well served to begin preparing now by taking several steps:

- Review all areas where estimates are critical to financial reporting and disclosures.
- Review accounting policies and procedures to determine the extent to which the process is documented and the potential for management bias is reduced.
- Review processes to confirm that they actually comply with the documentation.
- Determine if subjectivity can be reduced in critical areas by relying on the expertise of third parties.
- Review the status of SOC 1 Reports (System and Organization Controls Report) from third party advisors with the audit firm to evaluate whether additional reports will be required under the new guidance.
- Evaluate financial models and IT systems for data integrity and controls.
- Review current disclosures to determine if additional disclosure regarding the reliance on estimates and the estimation process should be made.

The renewed emphasis by both AICPA and PCAOB on the review of estimates in financial reporting serves as a reminder that professionalism in the field of accounting requires technical expertise and judgment, coupled with a freedom from bias to meet the needs of the market.

NEW IRS CRYPTOCURRENCY TAX GUIDANCE AND KEY HIGHLIGHTS

By Shehan Chandrasekera, CPA

The Internal Revenue Service (IRS) has not provided any guidance on crypto taxation since the Notice 2014-21 issued in 2014. After nearly five years, on October 9, 2019, the IRS issued new guidance on cryptocurrency taxation in the form of a list of FAQs and a Rev. Rul. 2019-24.

The new guidance preserves the "property" treatment for cryptocurrency for tax purposes and sheds more light into some controversial areas in this fast-changing space. It should be highlighted that this new guidance will only be applicable to taxpayers who hold cryptocurrencies as a capital asset. This article will highlight the key points you need to know.

Definition

For the first time, the IRS provides a definition for cryptocurrency in the new FAQs. Per the IRS: "Cryptocurrency is a type of virtual currency that uses cryptography to secure transactions that are digitally recorded on a distributed ledger, such as a blockchain. A transaction involving cryptocurrency that is recorded on a distributed ledger is referred to as an "on-chain" transaction; a transaction that is not recorded on the distributed ledger is referred to as an "off-chain" transaction." IRS Notice 2014-21 only defined and explained virtual currencies and convertible virtual currencies.

Forks

In the crypto world, a fork happens when a distributed ledger undergoes a protocol change and a diversion. After a hard fork, legacy users end up with a new cryptocurrency in addition to the old coins in their wallets. A soft fork is still a diversion of the legacy blockchain protocol, but the users will not end up with a new coin.

Hard Forks and Soft Forks. One of the most controversial positions described in the new guidance is that new coins received after a hard fork are taxed as ordinary income. The ordinary income realized is equal to the fair market value of the new cryptocurrency when it is received. If you do not receive new cryptocurrencies after a hard fork, you will not have any taxable income. This situation is called a soft fork.

This ruling is controversial because there are myriad scenarios in which users may face taxable income without knowing about it. For example, millions of Americans received BSV as a result of a bitcoin cash (BCH) hard fork. Due to limited liquidity and delisting of

the asset on many exchanges, these taxpayers are now faced with income on this asset that is difficult for them to dispose of.

Valuation

The IRS specifies guidance on exactly how to value crypto assets for tax purposes. If you trade crypto on an exchange like Coinbase or Binance.us, the dollar value for crypto traded should be determined by the USD price at that specific exchange. This means using sources like CoinMarketCap would not be acceptable anymore in converting cryptocurrency units into USD.

If you traded crypto peer-to-peer, via a decentralized exchange or some other method that did not involve an exchange, the fair market value of the crypto traded should be determined by referring to "a blockchain explorer that analyzes worldwide indices." If you do not use a blockchain explorer value, you must establish that the value you used is an accurate representation of the cryptocurrency's fair market value.

Finally, if you receive cryptocurrency for which you cannot find a published value (very common in the crypto world), the fair market value of the crypto received is equal to the fair market value of property or services exchanged.

Tech tools are available to automate the valuation process and generate reportable amounts in USD.

Following these valuation methods may be cumbersome for both taxpayers and tax practitioners in the upcoming tax season, but there are tech tools available to automate the valuation process and generate reportable amounts in USD.

Basis

Another major update on the new guidance is that specific identification is now officially an accepted accounting method for trading crypto assets. To successfully identify a specific unit, the information must include:

- The date and time each unit was acquired;
- Your basis and the fair market value of each unit at the time it was acquired;
- The date and time each unit was sold, exchanged or otherwise disposed of; and
- The fair market value of each unit when sold, exchanged or disposed of, and the amount of money or the value of property received for each unit.

If you cannot specifically identify the units, you must default to first-in-first-out (FIFO).
Since cryptocurrency exchanges are not issuing Form 1099-B, it becomes taxpayers' and/or tax practitioners' responsibility to keep track of the above info and calculate annual gains and losses. This is an extremely tedious task. Tax practitioners should consider using a reputable provider to aid in cryptocurrency accounting.

Gifts and Donations

If you receive crypto as a gift, you will not have to recognize any income. Determining the basis of the cryptocurrency gift received follows the general rules applicable to property donations; i.e., the basis of the gift received is dependent upon the gain or loss at the time you dispose of it.

Cryptocurrency donations will not trigger a gain or loss. If you have held the asset for more than one year, you are eligible for a deduction equal to the fair market value at the date of donation. If you have held the asset for one year or less, you are eligible for a deduction equal to the lesser of the fair market value or the cost basis at the date of donation. This allows you to donate appreciated crypto assets to charities and bypass capital gains taxes.

Payments

The IRS has confirmed that if you pay somebody in cryptocurrency and/or use crypto to purchase goods and services, that will trigger a capital gain or loss. The gain/loss is equivalent to the difference between cost basis and fair market value at the date of disposition.

Transfers

Transferring crypto from one wallet (or exchange) to another is a nontaxable transfer. These transactions may be included in Form 1099-K issued by crypto exchanges, but even if you receive a 1099-K, those transactions will not be taxable. This is a great relief for taxpayers who received various tax notices (CP2000, 6173, 6174-A and 6174) related to mismatching 1099-Ks.

It is great to see the IRS bringing more clarity to cryptocurrency related transactions. The majority of the items mentioned in the new FAQs are taxpayer friendly. Solid substantiation of your crypto transactions and proper reporting based on new guidance will be extremely important for taxpayers in the future.

About the Author:
Shehan Chandrasekera, CPA, is head of tax strategy at CoinTracker. In addition to his role with CoinTracker, he leads the Technology & Startup niche at JAGArgueta CPAs in Houston and serves as the associate director for the Houston Blockchain Alliance. Contact him at shehan@cointracker.io.

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SAVE TIME BY USING RECURRING TRANSACTIONS IN QUICKBOOKS ONLINE

By Jennifer Johnson, CPA

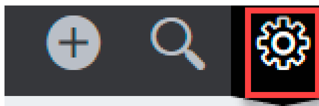
Recurring transactions is a feature in QuickBooks Online that allows you to save time and reduce mistakes. By using recurring transactions, you can automate repetitive journal entries, set invoices to generate automatically for subscription-type customers, or automate writing of a check or entering a bill. Recurring transactions can also be used to create a template for complicated or long journals or invoices. This feature is referred to as Memorizing a transaction in QuickBooks Desktop.

QuickBooks Online allows you to automate many types of transactions. The most common types of recurring transactions include: Bill, Check, Expense, Invoice, Journal Entry, Purchase Order, Sales Receipt and Purchase Order. You cannot automate Deposits or Bill Payments. Once a recurring transaction is created, you can choose the type and frequency.

Table 1 shows the types of recurring transactions and examples of their uses.

Steps to Create a Recurring Transaction

1. Select the **Gear Icon** from the Icon bar.



2. Select **Recurring Transactions** from the **List** column.

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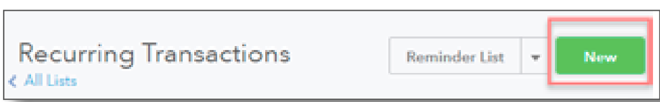
Custom Form Styles	Recurring Transactions	Reconcile
Chart of Accounts	Attachments	Budgeting
QuickBooks Labs		Audit Log
		Order Checks
		SmartLook

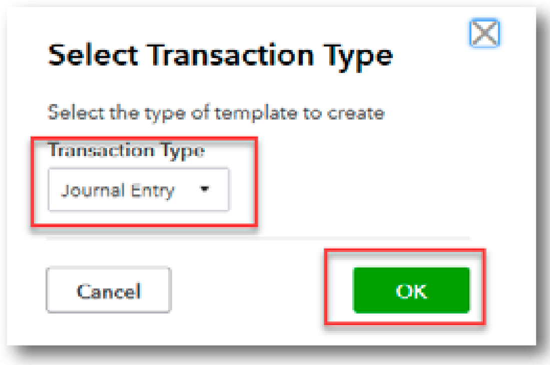
Table 1.

Type	Description	Example of Use
Scheduled	This type of recurring transaction creates the selected transaction automatically according to the schedule specified.	Best for transactions that have a fixed amount and fixed schedule, such as: • Customers who are invoiced the same amount each month. • Monthly journal entry to amortize a prepaid asset.
Reminder	This type of recurring transaction reminds the user to create the transaction using the template. Transactions are not generated or saved until the user decides to create them.	Best for transactions with a fixed schedule that need to be edited before they are created, such as: • Utility bills. • Purchase orders for regularly ordered items where the quantity varies.
Unscheduled	This is a template of a transaction that is saved but the transaction is not necessarily complete. This template reduces the need to retype the lines each time it is used.	Best for complicated transactions like a journal entry containing multiple lines with amounts that vary or a frequency that varies, such as: • Payroll journal entry.

3. Select **New** to start a new transaction.



4. Select the Transaction type and **OK.**



5. Complete the following seven areas on the recurring template screen:

A. Template Name: Give the template a name.

B. Type: Select from the three types of recurring transactions (Scheduled, Reminder, Unscheduled).

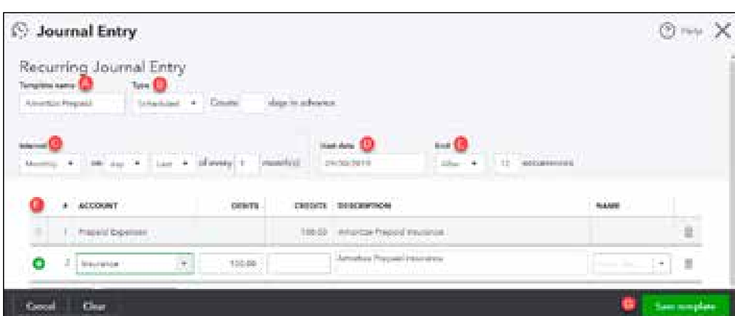
C. Interval: Select the interval (Daily, Weekly, Monthly, Yearly) and the day to recur.

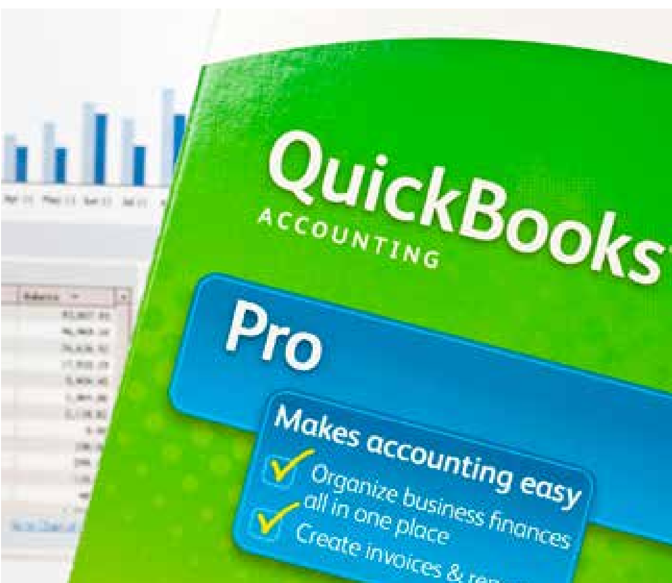
D. Start Date: Select the date to start the recurring transactions (must be after the creation date).

E. End: You can select "none" if this transaction will run forever; or select a specific end date or specific number of occurrences to repeat.

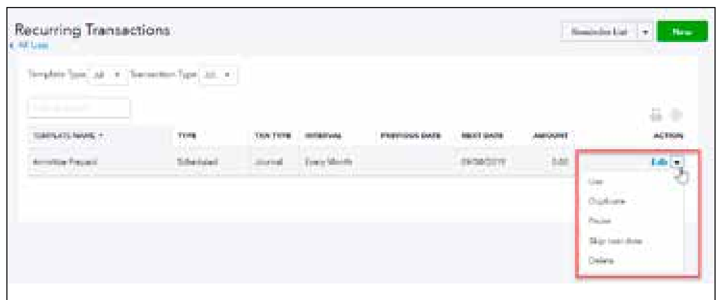
F. Template Body: Fill in the body of the transaction.

G. Save template: Select Save template to save your work.





6. Once the recurring transaction is created, you can manage your recurring transactions from the Recurring Transactions list using the Edit drop-down in the Action column.



About the Author:

Jennifer Johnson, CPA, is a Sr. Lecturer at the University of Texas at Dallas and a co-author of Computerized Accounting Using QuickBooks Online. Contact her at Jennifer.johnson@teachacct.com.

BEN SIMISKEY, CPA/PFS, CFP®

In this issue of *Today's CPA*, we spotlight **Ben Simiskey**, CPA/PFS, CFP® in Houston. He serves clients as director of wealth management at Stegent Equity Advisors, Inc. He is on TXCPA's Board of Directors, has served on several committees at the Society and chapter level, and recently finished his term as TXCPA treasurer. He now chairs the Strategic Planning Committee for both TXCPA and TXCPA Houston.

As part of his work with the TXCPA Strategic Planning Committee, he has been visiting chapter leaders and members across the state to gather input. A recent all-member survey also collected feedback that will be used in the strategic planning process.

Additional opportunities for input are planned for the next few months and you'll be hearing more about the progress throughout 2020 as the committee continues to build the strategic plan for the next three-year cycle.

If you'd like to chat with Ben about the Society's strategic planning, you can email him at ben@cpadvisers.com or text him at 312-515-3107. You can also find him and connect on TXCPA Exchange or any major social media network (@BenSimiskey).

"I've been blessed by the decision to become a CPA. Every job I've had since and every significant professional opportunity has been made possible by my license."

– BEN SIMISKEY

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In addition to providing wealth management solutions to your clients at Stegent Equity Advisors, Inc., you are an adjunct instructor at Rice University. What makes you so passionate about wealth management and planning?
I suppose it's appropriate I've been asked to be part of our strategic planning efforts, because I have a very planning-centric career and mindset. Even the class I teach at Rice is a tax planning course. At Stegent, I specialize in financial planning for sole decision makers – women and men who are widowed, divorced or single, or who are the primary caregiver for an ill or aging spouse. Planning during this period of time can be incredibly stressful and difficult but especially important.

As a single parent, I understand the need for support in the decision-making process when you're on your own. I've also seen it in the lives of family, friends and clients. Recently, I witnessed it in the life of my mom after we lost my dad to cancer in March. They had been married 53 years. That's not a void that can be completely filled but loved ones and professionals can help ease the burden. By acting as my clients' personal CFO, that's what I do for them. I help ease their burdens and support them in reaching their unique goals.

At what point in your life did you know you wanted to be a CPA?
Actually, someone had to persuade me to get my CPA license! That's strange to think about now but I had different goals at the time. After graduating with my bachelor's degree in Accounting from BYU, I was working in Deloitte's audit department in Chicago. At that time, I planned to go down the CEO career path and was going to pursue my MBA. I had even taken the GMAT and done campus visits.

Fortunately, I trusted the great mentors I had in my life who helped me to see that I should work for a couple more years before applying and, in the meantime, I should get my CPA license. Once I decided to go in that direction, I was all in. I passed all four parts of the CPA Exam on my first sitting and was off and running.

Years later, I can see how much I've been blessed by the decision to become a CPA. Every job I've

had since and every significant professional opportunity has been made possible by my license.

You've traveled around Texas the last few months to meet with members as part of the TXCPA strategic planning process. Did you learn anything interesting about Texas history you didn't know before?

This great state has no shortage of history and I always learn new things during my trips. I grew up mostly in Texas and took Texas History in school, so I already knew a lot of the most common facts. When I can, I love going beyond those facts and digging into individual stories – how people got here, what life is like in their town, what their community means to them. Meeting so many of our chapter leaders I didn't previously know or didn't know well gave me a lesson in Texas history I couldn't have gotten anywhere else.

Getting to know so many members and their communities has been enormously energizing for me and is vital to our strategic planning process. Our members have welcomed me into their chapters, their communities, their offices and homes. Texas is about community, and TXCPA is a powerful and unique community of its own.

Why is volunteering in TXCPA and your community so important to you?
My parents taught us that "to whom much is given, much is required." It's remarkable how much most of us have been blessed with here in the United States. We're incredibly wealthy – in far more than money. I think we have an obligation to share our talents and blessings with others.

But I also believe there's a higher reason for volunteering than obligation. Ultimately, it's about love and knowing what's important to you. I decided a long time ago that I was going to make it a priority to always be involved in organizations and causes meaningful to me. The most important areas of my life include my faith, family, country/community, profession and humanity. So, I include service in each of those areas in my personal strategic plan.

None of us can do everything. But we can each do something. We can all make a difference in the areas most meaningful to us.

Tell us about your personal life and interests. What do you like to do on weekends or when you're on vacation?
There's nothing I enjoy more than being a dad. Most of my free time is spent with my boys – Noah (15) and Sam (13). We love sports and are usually either playing or watching. We also share a love for road trips. Over the past several years, our road trips have taken us to all 48 states in the continental United States.

I'm also a proud Eagle Scout and enjoy camping and trying new things with my boys. Learning and living the Scout motto ("Be Prepared") as a youth is what initially sowed the seeds of my passion for planning.

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Highlights from TXCPA's Month of Service

TXCPA members participated in another successful **Month of Service** in November!

The Young CPAs and Emerging Professionals Committee hosted the Month of Service, which gave members the opportunity to lend a helping hand in a volunteer activity of their choice and give back to their communities.

Check out the photos below for just a few highlights from TXCPA chapters throughout the state.

TXCPA Launches a New Campaign – The CPA Advantage – to Promote the Profession

TXCPA recently launched a new promotional campaign – The CPA Advantage – to help CPAs, future CPAs and TXCPA chapters promote Texas CPAs to the public. Our new online digital toolkit provides a variety of helpful resources to assist members in growing their firms or companies, differentiating their services, and increasing awareness of the CPA profession.

Log in today at https://www.tscpa.org/resources/the-cpa-advantage to download and take advantage of these new resources available exclusively for members.

Follow Up on *Today's CPA* Article "Revenue Contracts and Allowance for Credit Losses"

The November/December issue of *Today's CPA* magazine included an article written by Josef Rashty titled "Revenue Contracts and Allowance for Credit Losses … Application of CECL to Revenue Contracts Within the Scope of ASC 606." The article covered issues related to Financial Accounting Standards Board (FASB) ASU 2016-13, *Financial Instruments – Credit Losses (Topic 326) Measurement of Credit Losses on Financial Instruments.*

Subsequent to press time and publication of the article, FASB issued narrow-scope changes to the

Highlights from TXCPA's Month of Service

standard with the release of ASU No. 2019-10 in November. FASB has deferred the effective dates of the standard for all entities except SEC filers that are not smaller reporting companies to fiscal years beginning after Dec. 15, 2022, including interim periods within those fiscal years.

For more information about the changes, please go to FASB's website at www.fasb.org and search on "ASU 2019-10."

Outstanding Accounting Educator Award Nominations Due March 1

Do you know accounting educators who deserve recognition? Be sure to nominate them for an Outstanding Accounting Educator Award! TXCPA is accepting nominations through March 1, 2020.

This award recognizes Texas accounting educators who have demonstrated excellence in teaching and have distinguished themselves through active service to the accounting profession. The recipients will be honored during TXCPA's annual Accounting Education Conference, and each recipient will receive a $500 award, a recognition plaque and complimentary registration to the Accounting Education Conference.

For more information and to complete the nomination form, please go to the TXCPA website at https://txcpa-awards.secure-platform.com:443/a or contact TXCPA's Bryan Garza at bgarza@tscpa.net or 800-428-0272, ext. 255 (972-687-8555 in Dallas) for more information.

Your Next Issue of *Today's CPA* Magazine Will Be Digital!

Your March/April issue of *Today's CPA* will be available in a digital format. Watch your inbox for details and enjoy the convenience of this valuable member resource on your device or home or office computer.

STATEMENT OF OWNERSHIP

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DeLynn Deakins 14651 Dallas Parkway, Suite 700
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PS Form **3526**, July 2014 (*Page 2 of 4*)

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Managing Editor

Date: 09/27/19

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OPPORTUNITY ZONES GAIN TRACTION ... AND OPPOSITION

By Rolando Garcia, JD, CPA, Shareholder

Created to encourage economic growth and investment in low-income and economically distressed communities, the Tax Cuts and Jobs Act[1] created a new tax incentive for investors to consider – Qualified Opportunity Funds (QOF). QOFs work such that taxpayers are able to defer paying tax on capital gains by investing those capital gains into a QOF, which in turn invests those funds within a Qualified Opportunity Zone (QOZ).[2] A QOZ is a population census tract in a low-income community that is formally designated as such by the U.S. Treasury Department.[3] (The complete list of such designated areas can be found at https://www.irs.gov/pub/irs-drop/n-18-48.pdf.)

While the interest level from taxpayers wanting to defer recognition of capital gains was expectedly high at the onset, so was the uncertainty. However, with the issuance of the initial proposed regulations in October 2018[4] and the proposed regulations in April 2019[5], many of those uncertainties (though not all) have been lifted. As a result, financial advisors, developers and taxpayers have begun the machinations necessary to create the investments envisioned by Congress when it enacted the program.

Since January 2019, QOF investments have grown almost six-fold.[6] The U.S. Economic Development Administration (EDA) added QOZs as an "investment priority" with the intent of increasing the number of QOZ-related projects that it can fund to spur greater public investment in QOZs.[7] In fact, as of December 2, 2019, the EDA has invested close to $342 million in almost 250 projects since the OZF incentive was created.[8]

QOFs have a series of timelines and thresholds, including a sunset date of December 31, 2026.[9] (December 31, 2019[10] was a sunset date insofar as one of the tax-favored features is concerned.) But first, here is a brief summary of the program.

Opportunity Zones

Eligible taxpayers can, within 180 days of a sale or exchange generating an eligible gain, elect to reinvest all or a portion of such a gain into a QOF, deferring its recognition until December 31, 2026, or, if earlier, the date the taxpayer sells or exchanges the QOF interest.[11]

Eligible taxpayers include individuals, C corporations, S corporations, partnerships, and trusts and estates. Eligible gains are those treated as "capital" gains, to the extent such gains do not arise from a sale or exchange with a

related party, and include short-term and long-term, unrecaptured 1250 gain, and net section 1231 gain. Any depreciation recapture as ordinary income under sections 1245 and 1250, however, is not eligible gain.

Opportunity Zone Tax Benefits

There are three types of tax benefits that investors can attain from investing in a QOF – an investment vehicle organized either as a corporation or a partnership mainly for investing in QOZ property. The QOF is deemed to be conducting business in a QOZ either directly, by holding QOZ business property, or indirectly, by holding QOZ stock or a QOZ partnership interest of a corporation or a partnership, respectively, conducting business within a QOZ. (There are timelines and quantitative thresholds that must be met, which will be covered in detail later.)

In general, investments in QOZs may permit investors to:

- Defer the tax on any eligible capital gain until December 31, 2026, if that gain is invested by the taxpayer in a QOF within 180 days of the date the gain was recognized;
- Reduce up to 15% of eligible gains invested in a QOZ depending on the investor's holding period, namely 10% if the investor holds the qualifying investment for at least five years and an additional 5% if the investor holds the investment for an additional two years; and
- Increase the tax basis of their interest in a QOF to fair market value on the date of sale if they hold their interest in the fund for at least 10 years, meaning that the investor should not recognize gain on the sale of its qualifying investment.

Thus, for example, if an eligible taxpayer has $100 of capital gains and timely invests this into a QOF and holds the investment for 10 years, this taxpayer would be able to:

- Defer the tax owed on the original $100 of capital gains until 2026;
- Increase the basis of the underlying asset by 15%, thereby effectively reducing the $100 of taxable capital gains to $85; and
- Owe NO capital gains tax on its appreciation.

Assuming the $100 investment grows 7% annually, the after-tax value of the original $100 investment after 10 years would be $176, the sale of which would not be subject to any additional tax.

Meeting the Requirements

As detailed above, an eligible taxpayer may elect to defer a capital gain if, within 180 days of the sale or exchange, some or all of the gain is reinvested into a QOF. A QOF is an entity with a specific purpose that acts as a conduit towards achieving the legislative intent of ensuring

that the amounts represented by deferred capital gains are ultimately deployed in a qualified opportunity zone business (QOZB).

With respect to the 180-day requirement, if the taxpayer yielding the capital gain is a pass-through entity, it will have a choice as to when the measurement date begins. The pass-through may elect to defer that gain at the pass-through level or it may pass the gain through its partners (in the case of a partnership), who then can make their own decision as to deferral. If the distributees hold the power to elect, their measurement date would begin on the last day of the pass-through entity's tax year, as opposed to on the date of sale.

A QOF may be organized as a corporation or partnership (including an LLC) and may be a newly formed or even a pre-existing entity. While a QOZB must operate within a QOZ (more on this later), a QOF need not be located in a QOZ.

A QOF must have at least 90% of its assets invested in QOZ property, measured as the average of the "QOZ property" held in the QOF on the last day of the first six-month period of the QOF's taxable year and on the last day of the QOF's taxable year. Failure to meet this test will result in a penalty for each month that it fails to meet the threshold (based on the underpayment rate for a particular month).

To the extent such assets are held by the QOF in the form of cash, cash equivalents or short-term debt instruments, any cash or cash equivalents received by the QOF in the preceding six months as a contribution to capital are not taken into account in measuring the 90% test. This provision will provide operational relief in that QOFs need not hastily deploy contributed capital into QOZ property.

As mentioned previously, "QOZ property" can be one of three things:

- QOZ stock;
- QOZ partnership interests; and
- QOZ business property.

The last option permits a QOF to directly operate a QOZB that utilizes qualified opportunity zone business property (QOZBP), as long as at least 70% of such property is used within a QOZ for at least 90% of the time that the QOF owned the property. Such business property includes the following, if acquired after December 31, 2017:

- Machinery and equipment;
- Furniture and fixtures;
- Tenant improvements; and
- Land acquired.

In addition, the original use of the business property in the QOZ must commence with the QOF, or alternatively, improvements equaling at least 100% of the adjusted basis of the subject property must be made to the property during a 30-month period following acquisition.

Alternatively, a QOF may indirectly meet the 90% threshold by conducting a QOZB through a subsidiary by holding QOZ stock or a QOZ partnership interest. Under either indirect method:

- The QOF must have acquired the stock or partnership interest after December 31, 2017;
- The underlying corporation or partnership is, or is organized to be, a QOZB;
- During 90% of the time that the QOF holds the stock or partnership interest, the underlying entity is a QOZB with at least 70% of its business property being used within a QOZ;
- At least 50% of the business's total gross income is derived from the "active conduct of a trade or business;"
- At least 40% of the business's intangible property is used in the "active conduct of a trade or business;"
- Less than 5% of the aggregate unadjusted bases of the property of the trade or business is attributable to nonqualified financial property; and
- The QOZB cannot be a "sin" business, namely private or commercial golf courses, country clubs, massage parlors, gambling facilities and any establishment at which the primary business is the sale of alcohol.

There is a series of "loaded" terms in the quantitative tests applicable to a QOF investing through a corporation or partnership, namely (1) "50% of gross income," (2) "active conduct of a trade or business," and (3) "nonqualified financial property."

The proposed regulations released in April 2019 provide three safe harbors and a broad facts and circumstances test for determining whether the "50% of gross income" test is met, meaning that this test will be deemed to be satisfied if:

- At least 50% of the services performed (based on hours) for the business by its employees and independent contractors (and employees of independent contractors) are performed within the QOZ;
- Based on amounts paid for the services performed, at least 50% of the services performed for the business by its employees and independent contractors (and employees of independent contractors) are performed in the QOZ;
- The tangible property located in, and management or operational functions performed in, the QOZ are each necessary for the generation of at least 50% of the gross income of the trade or business; and
- Based on the facts and circumstances, at least 50% of the gross income of a trade or business is derived from the active conduct of a trade or business in a QOZ.

Statistics show that investments in QOFs are on the rise.

"Active trade or business" is not defined in the statute or in the proposed regulations. Ostensibly, IRC §162 and the vast body of authoritative guidance thereunder provides the roadmap for how this should be interpreted in the QOZ context. Importantly, the proposed regulations make clear that the operation (including leasing, but only if not solely triple net leasing) of real property is deemed to be the "active conduct of a trade or business."

The reader will recall that no more than 5% of the aggregate unadjusted bases of the property of the trade or business can be attributable to "nonqualified financial property," which includes debt, stock, partnership interests, options, futures, forwards, warrants, swaps, etc. However, it does NOT include "reasonable amounts" of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less. These are categorically called "Working Capital Assets."

Under the regulations, "working capital assets" will be deemed to be held in "reasonable amounts" if:

- The working capital assets are designated in writing for the acquisition, construction, and/or substantial improvement of tangible property in a QOZ or the development of a trade or business in the QOZ;
- There is a written spending schedule that is consistent with the ordinary start-up of a trade or business;
- The working capital assets are spent within 31 months of the receipt by the business of such assets; and
- The working capital assets are actually used in a manner consistent with the written designation and the spending schedule.

Gain Recognition

As mentioned above, gain is recognized on the earlier of the date that the QOF investment is sold or exchanged, or December 31, 2016. "Sold or exchanged" includes any transaction that reduces the QOF investor's equity interest, including:

- A taxable disposition of the qualifying investment;
- Except in certain limited cases, a transfer by a partner of an interest in a partnership that itself directly (or indirectly solely through other partnerships) holds a qualifying investment;
- A transfer by gift of a qualifying investment; and
- Certain nonrecognition transactions, including (i) a disposition of qualifying QOF stock in a section 332 liquidation of the QOF corporation that issued such stock and (ii) a transfer of qualifying QOF stock in a section 351 transaction to the extent the transfer would reduce the transferor's direct interest in the QOF.

However, neither the transfer of the qualifying investment to a decedent owner's estate nor the distribution by the estate to the decedent's heir will be considered an inclusion event.

There are several watershed dates in the QOZ regime, of which December 31, 2019 was one. The reader will recall that one of the tax benefits of investing in a QOZ is a deferment on recognition of the tax on any eligible capital gain until December 31, 2026 and that such investors may eliminate up to 15% of eligible gains if they hold the qualifying investment for at least seven years. (Plotting this against the calendar means that an eligible investment needed to have been made on or before December 31, 2019 to attain the full 15% haircut.)

Addressing the Uncertainties

Granted, unanswered questions remain. For example, "merely entering into a triple net lease" is not the active conduct of a trade or business. But what definition of a triple net lease is applicable? What if a lessor pays one of the three – is this sufficient to avoid the rule? Or does the lessor need to meaningfully participate in the management or operations?

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Nonetheless, investors, developers and financial advisors have been gaining confidence that there are more knowns than unknowns. Like any other significant investment, all parties with a stake in the successful outcome will, as they should, fully vet the business aspects of the underlying "deal" so that the tax benefits add the proverbial "cherry on top."

Most recently, the QOF program has come under criticism for benefiting wealthy donors, with several articles in *The New York Times* and *ProPublica* questioning the allocation of Opportunity Zone tracts. At the opposite end of the QOF spectrum, Congresswomen Rashida Tlaib (MI-13) and Pramila Jayapal (WA-07) introduced legislation to repeal QOFs from the United States tax code.[12]

Notwithstanding the sluggish start, the statistics show that investments in QOFs are on the rise. Full transparency and constant communication between the investor, QOF and developer are the keys towards ensuring that the flow and use of funds comply with the many thresholds and safe harbors contained in the rules to avoid penalties.

ABOUT THE AUTHOR:

Rolando Garcia, JD, CPA, is a shareholder at Doeren Mayhew CPAs and Advisors in Houston. Contact him at rgarcia@doeren.com.

FOOTNOTES:

[1] Tax Cuts and Jobs Act, §13823, Pub. L. No. 115-97, 131 Stat. 2054, 2184 (2017)
[2] 26 U.S.C. §1400Z-2 (2017)
[3] 26 U.S.C. §1400Z-1 (2017)
[4] REG-115420-18, 83 F.R. 54279 (10/29/18)
[5] REG-120186-18, 84 F.R. 18652 (5/1/19)
[6] NES Financial Opportunity Zone database. *Aggregated inflows from January – August 2019.*
[7] U.S. Economic Development Administration, (2019, June 12). *U.S. Economic Development Prioritizes Applications for Projects Located in Opportunity Zones* [Press Release]. Retrieved from https://www.eda.gov/news/press-releases/2019/06/12/opportunity-zones.htm
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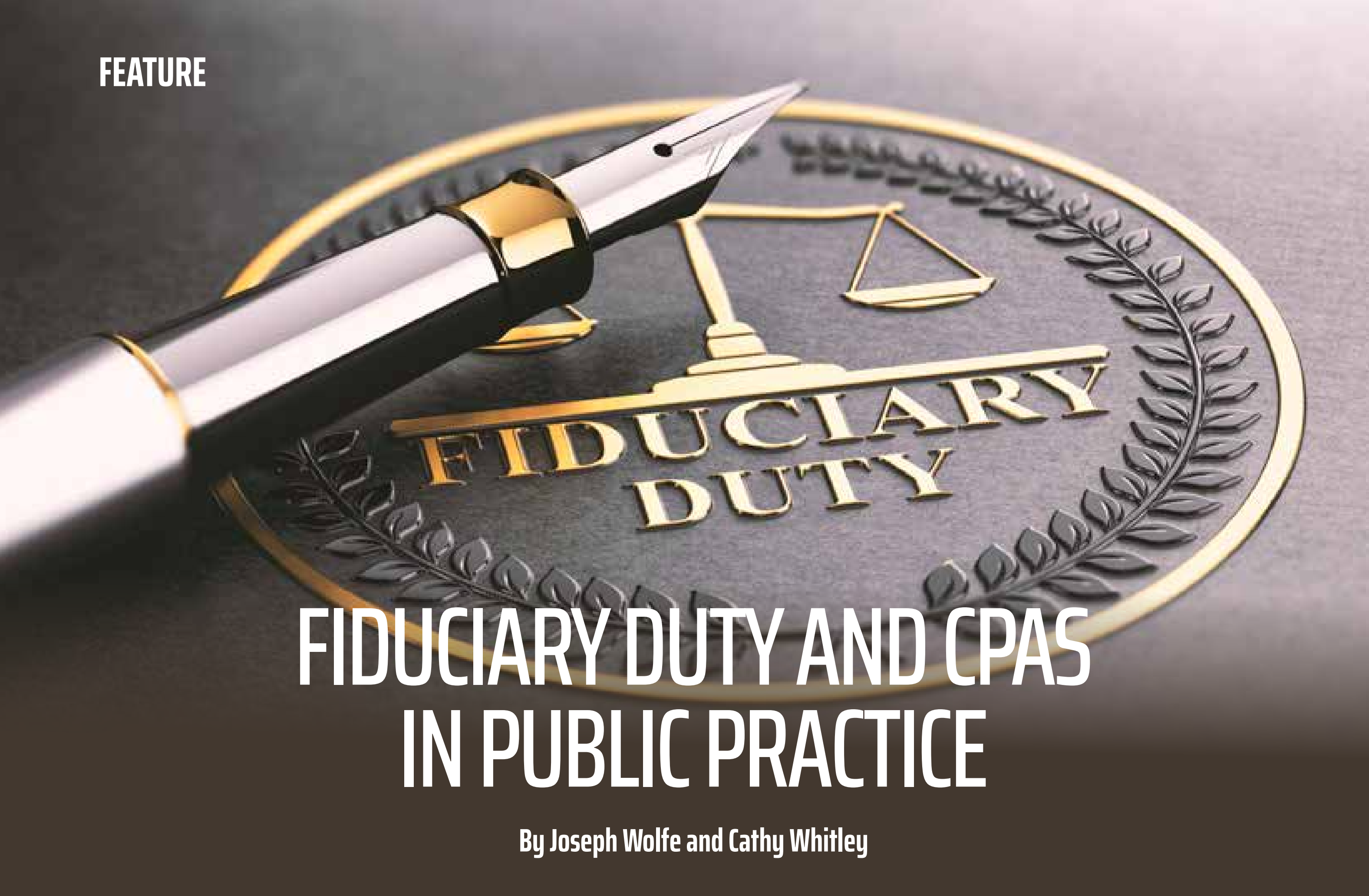
[9] 26 U.S.C. §1400Z-2(a)(2)(B) (2017)
[10] 26 U.S.C. §1400Z-2(b)(2)(B)(iv) (2017)
[11] Except as may be noted in subsequent endnotes, the authority for the authoritative statements hereinafter are 26 U.S.C. §§1400Z-1 and 1400Z-2 (2017) and/or REG-115420-18, 83 F.R. 54279 (10/29/18) and/or REG-120186-18, 84 F.R. 18652 (5/1/19).
[12] The Repeal Opportunity Zones Act of 2019, H.R. 5252, 116th Cong. (2019).

FEATURE



FIDUCIARY DUTY AND CPAS IN PUBLIC PRACTICE

By Joseph Wolfe and Cathy Whitley

CPAs in public practice are often approached about assuming a role or rendering services that generate a fiduciary duty to the client. While the courts have not defined fiduciary duty, it is the highest standard of care. Fiduciaries are required to act solely in the best interests of the business or individual they serve.

The legal definition of a fiduciary listed in the Merriam-Webster dictionary is:

"one often in a position of authority who obligates himself or herself to act on behalf of another (as in managing money or property) and assumes a duty to act in good faith and with care, candor and loyalty in fulfilling the obligation: one (as an agent) having a fiduciary duty to another"[1]

The operative term in this definition is "*...who obligates himself or herself to act on behalf of another.*"

Ordinarily, CPAs do not obligate themselves to act on behalf of a client when rendering professional services. Consulting services involve providing advice and recommendations to clients, for their consideration and action. CPAs likewise do not act on the client's behalf in preparing tax returns, accounting records or financial statements for clients. CPAs do not act on the client's behalf when performing auditing and attestation services; in fact, CPAs are required to remain independent in fact and appearance when providing these services.

However, CPAs and other professional staff may undertake a fiduciary obligation to clients when they assume specific roles.

Power of Attorney for Tax Matters

Many CPAs have clients sign IRS form 2848, Power of Attorney and Declaration of Representative. While this may be required for the CPA to represent a client in an audit of previously filed tax returns, sometimes the form is signed for the convenience of the client to receive and transmit communications to and from the IRS.

Upon signing this form as the client's representative, the tax practitioner is assuming a fiduciary duty by agreeing to act on the client's behalf in these communications. In the event the practitioner failed to timely respond to an IRS communication, this could result in the disallowance of a tax return position taken by the client and the imposition of taxes, penalties and interest. Note that the client's failure to timely respond to the practitioner's requests regarding these communications does not relieve the fiduciary duty; however, it can serve as a defense in the event of a claim.

Risk Management: It's important to require the client to sign an engagement letter that acknowledges his/her duty to promptly respond in writing to any communications received under the power of attorney, holding both the individual and the CPA firm harmless from any claims or damages that result from the client's failure to timely provide specific instructions in response to these communications.

Before agreeing to serve as a registered agent for a client, consider the situation and related risks.

Consider the need before submitting federal or state power of attorney forms to clients for signature. Unless a client is under audit, clients should remain responsible for receiving all written notices from taxing authorities and promptly transmitting them to their accountant for review. Explain this responsibility to clients and consider including this information on your firm's website and with the annual tax organizer provided to clients.

Investment Adviser

An investment adviser assumes a fiduciary obligation to his/her clients. Investment advisers are subject to registration and oversight by federal or state regulators. *The Investment Advisers Act of 1940* defines an investment adviser as a person who, for compensation, is engaged in the business of providing advice to others or issuing reports or analyses regarding securities.[2]

While most CPAs do not render such services, the analysis needed to determine whether registration is required can be complex. Additionally, CPAs may unwittingly undertake this role by agreeing to access online client investment accounts or communicate with securities brokers on behalf of clients to buy or sell securities (including mutual funds). In addition to exposing themselves to potential claims of breach of fiduciary duty, CPAs may run afoul of laws and regulations applicable to investment advisers. Undertaking this activity for an employee benefit plan also requires maintenance of a fidelity bond in accordance with ERISA Section 412.14.[3]

Risk Management: Investment advisers are subject to extensive regulatory oversight. Consult with industry experts regarding compliance. *The CPA's Guide to Investment Advisory Business Models*, a useful reference piece that discusses fiduciary duty and details investment adviser registration requirements, is available at no charge from the Personal Financial Planning Section of AICPA.[4] Both investment advisers and individuals who provide occasional investment advice should utilize these and other resources available to members of the Personal Financial Planning Section of AICPA.

Only investment advisers who are registered with federal or state regulators as required and have the requisite knowledge, experience, training, oversight and controls should provide advice regarding securities. Avoid accepting electronic access to client investment accounts or communicating with securities brokers on behalf of a client to authorize the sale or purchase of securities.

Registered Agent

A registered agent receives legal documents and service of process for a business registered in that state. In some states, this role is defined as resident agent or statutory agent. CPAs sometimes agree to serve as a registered agent for a client who has established a business in the state where the CPA resides, for the convenience of the client. Like assuming power of attorney for tax matters, the client's failure to timely respond to the inquiries of a registered agent does not relieve the fiduciary duty.

Risk Management: Before agreeing to serve as a registered agent for a client, consider the situation and related risks. Confirm the citizenship of the client and his/her state of residence. Clients who are not U.S. citizens or reside outside of the U.S. may present unique problems. Why is the client requesting this service and why isn't he/she utilizing a professional registered agent service? This is a service that can be obtained online quickly and inexpensively from established national providers.

Are there potential legal or tax concerns surrounding the registration of the business in the state? How difficult would it be to promptly establish written contact with, and receive a response from, the client in the event a legal document was received? It's important to conduct sufficient inquiry and investigation to reach a satisfactory conclusion before agreeing to serve in this role. Depending on the circumstances, it may be necessary to consult with legal counsel.

Be sure to include loss limitation language in the client engagement letter like that described for power of attorney for tax matters when assuming this role.

Attorney in Fact

A person is appointed as an attorney in fact through a durable power of attorney signed by the individual providing this authority. An attorney in fact has overall responsibility for managing the financial affairs of that individual, including a wide variety of activities, such as managing real estate and other financial assets, paying bills and home maintenance expenses, and selecting and purchasing insurance.

Typically, this responsibility is only assigned when the individual in question is seriously ill or disabled. A person serving as an attorney in fact has a clear fiduciary duty to the individual granting the authority and can be held liable for any breach of these broad duties.

Risk Management: Serving as an attorney in fact is a significant responsibility. A person appointed as an attorney in fact often hires accountants to render various services, such as bill payment and tax return preparation. Accountants should have the attorney in fact sign an engagement letter defining the scope of service, terms of engagement and billing arrangements.

An accountant serving as an attorney in fact may face a conflict of interest in hiring his/her own firm to render services on behalf of the individual under Rule 102-2 of the AICPA Code of Professional Conduct, Conflicts of Interest for Members in Public Practice (Rule 102-2).[5] While such conflicts can be resolved by obtaining the written informed consent of the client and other affected parties, this becomes more complicated when a client is disabled. Professionals who have clients they believe are incapable of managing their financial affairs should consult with experts in elder care and elder law before undertaking any action. The AICPA Personal Financial Planning Section provides related resources.[6]

Trustee of a Testamentary Trust

It is not unusual for clients to request that their CPA serve as a trustee for a trust they have created for estate planning purposes. A trustee has overall responsibility for managing the assets in a trust, administering the trust and making trust distributions to beneficiaries. While a trustee can hire other professionals to assist in this process, the fiduciary duty of the trustee cannot be delegated to other professionals. Additionally, as discussed above, a trustee hiring his/her own CPA firm to render services to the trust faces a potential conflict of interest under Rule 102-2.

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Serving as a trustee is often time consuming and complex, and can be problematic when there are assigned co-trustees or trust protectors, and disputes or disabilities impacting trust beneficiaries.

Risk Management: Tax practitioners often assist clients in formulating estate plans and establishing trusts. It is typical that both the settlor of a trust and the trust beneficiaries are tax clients, presenting potential client confidentiality and conflict of interest problems upon the death of the settlor.

Serving as a trustee can also present legal liability and insurance coverage problems. Trust agreements should include a provision to defend and indemnify the trustee against claims, provided they act in good faith and in accordance with its requirements.

Practitioners who are designated as trustees for a client's trust or who are considering undertaking this role should read the *Journal of Accountancy* article, "The Unexpected Risks of Trustee Services."[7]

Executors and Personal Representatives

An executor is designated in a will or assigned by a probate court to manage the assets and liabilities of the estate of the decedent. An executor has a fiduciary duty to all the beneficiaries of the estate, regardless of the extent of the benefits assigned to them under a will.

Some states have established statutes based on the Uniform Probate Code, which allow for the designation of a personal representative. A personal representative serves in the role of an executor or administrator of the estate of the decedent and owes a fiduciary responsibility to the beneficiaries of the estate.

Risk Management: Ordinarily, a family member or an attorney with extensive knowledge and experience in estate law serves as an executor or personal representative for an estate. An executor or personal administrator often hires accountants to prepare estate tax returns and perform accounting services. A signed engagement letter should be obtained prior to initiating services to an executor or personal representative.

An executor or personal representative wishing to hire his/her own CPA firm to render these services faces a conflict of interest, which would require him/her to obtain the written consent of both co-trustees and estate beneficiaries prior to rendering services, in accordance with Rule 102-2. Such engagements present elevated risk to both the executor or personal representative and his/her CPA firm. Consult legal counsel with experience in estate planning and the firm's professional insurer prior to undertaking such engagements.

INSURANCE COVERAGE

Professional liability insurance policies are designed to provide coverage for exposures faced by accounting firms in the practice of public accountancy. Insurance coverage for the various fiduciary roles discussed in this article varies by policy.

Obtaining a power of attorney for tax matters is an ordinary role fulfilled by CPAs in the practice of public accountancy, as is bill payment. However, insurance coverage may be limited or excluded when serving in some of these roles. Consult with the firm's insurance agent or broker prior to agreeing to undertake these fiduciary duties.

Trustee in Bankruptcy and Receiver in Bankruptcy

A trustee is appointed by the bankruptcy court to manage the liquidation or reorganization of assets for a business in bankruptcy. The role and responsibilities of the trustee are defined by the order issued by the bankruptcy court. A trustee generally has immunity from civil liability when appointed by a bankruptcy court, but only when acting within the scope of the court's order.

A receiver is appointed by a bankruptcy court to manage the assets of a business to attempt to restructure a company and bring it into recovery. The role and responsibilities of the receiver are defined by the order issued by the bankruptcy court. A receiver generally has immunity from civil liability when appointed by a bankruptcy court, but only when acting within the scope of the court's order.

Risk Management: Specialized knowledge and training are required to serve as a trustee or receiver in bankruptcy. To obtain more information, consult with an attorney with expertise in bankruptcy law prior to pursuing services as a bankruptcy trustee or receiver.

In addition to the above roles, a CPA may otherwise gain access to a client's money or property in rendering professional services and undertake a fiduciary obligation.

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A common example of this is performing bill payment services for a client.

Risk management for these services includes engagement letters that specify the scope of services and define the authority provided by the client to review and pay specific bills, acknowledging the client's responsibility to review and approve bills for payment that are outside of this authority.

Mitigating the Risks

It is important to recognize that situations arise that can create a fiduciary duty while rendering professional services. It may be necessary to assume a fiduciary duty to perform some professional services. The related risks can be mitigated through training, supervision, effective communication and written documentation.

When in doubt, consult with your peers, legal counsel and your professional liability insurer prior to proceeding. Remember that in some situations, however, it may be best to "just say no" to requests from clients to assume a fiduciary role.

ABOUT THE AUTHORS:

Joseph Wolfe is a risk management consultant working with Aon Affinity. Previously, he worked with the program's underwriter, CNA. Wolfe has 37 years' experience in the insurance industry. For more information, visit www.cpai.com.

Cathy Whitley is senior AICPA risk advisor for Aon Insurance Services, the national administrator of the AICPA Professional Liability Insurance Program since 1974 and has more than 20 years' experience with Aon. For more information, contact her at cathy.whitley@aon.com or visit www.cpai.com.

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FOOTNOTES

[1]https://www.merriam-webster.com/dictionary/fiduciary

[2]Regulation of Investment Advisers by the U.S. Securities and Exchange Commission, https://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf

[3]Department of Labor Issues Guidance on ERISA Bonding Requirements, Bradley Benedict, Pillsbury law firm, December 10, 2008 https://www.pillsburylaw.com/images/content/2/0/v2/2063/59012A092AFB9BB3BB344FA03CE45FB7.pdf

[4]The CPA's Guide to Investment Advisory Business Models https://www.aicpa.org/content/dam/aicpa/interestareas/personalfinancialplanning/resources/pfppracticemanagement/pfppracticeguides/downloadabledocuments/cpa-guide-investment.pdf

[5]https://www.aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/DownloadableDocuments/2014/2014SeptemberOfficialReleases.pdf

[6]https://www.aicpa.org/interestareas/personalfinancialplanning/resources/elderplanningservices.html

[7]https://www.journalofaccountancy.com/issues/2016/jul/trustee-services-risks.html

IS LESS MORE?

TRENDS IN UTILIZING VALUATION DISCOUNTS IN ESTATE PLANNING

By Jamie T. Katzen

Utilizing valuation discounts of closely held business interests to supercharge gift and/or sale transactions, and to mitigate estate and gift tax liability, is a popular strategy for many estate planning practitioners and a boon to taxpayers with taxable estates. However, the ability to discount the value of an asset and lower a taxpayer's estate and gift tax liability is also a thorn in the side of the IRS. Therefore, it comes as no surprise that the applicability and usage of valuation discounts has provided one of the most spirited legal battles over the past few decades.

Estate Planning Techniques Using Valuation Discounts

The most popular estate planning technique (and, accordingly, the most derided one from the IRS' perspective) is the implementation of the "Family" Limited Partnership (FLP). A litany of case law[1] has provided estate planners with a game plan for how to successfully employ FLPs.

By splitting the FLP's voting and control rights among its limited partners and general partners, the taxpayer is able to obtain a valuation discount for lack of control, lack of marketability and others that routinely reach the 30%-50% range. These deep discounts on FLPs often result in otherwise taxable estates largely avoiding the estate and gift tax regime, especially in the post-Tax Cuts and Jobs Act environment.

§2704 Proposed Regs. and Trump Administration

Unsurprisingly, after years of back and forth in the courts, in 2016 the U.S. Treasury Department issued §2704 proposed regulations (Prop. Reg. §§25.2701-8, 25.2704-4(b)(1)-(2)) that were intended to provide the IRS with a new arrow in its quiver to limit and possibly eliminate valuation discounts for family-owned business entities (including FLPs). Naturally, business owners and their legion of advisors were very concerned by these developments.

In September 2016, mounting political pressure resulted in a group of 41 U.S. senators sending a letter to the Secretary of the Treasury requesting that the proposed regulations be withdrawn[2].

However, with the change in executive administrations came a change in the Treasury's backing and motivation to fight this cause. In April 2017, President Donald Trump signed Executive Order 13789, which directed the Treasury to examine recent tax regulations to determine whether any of the regulatory projects:

- Imposed an undue financial burden on U.S. taxpayers;
- Added undue complexity to the federal tax laws; or
- Exceeded the statutory authority of the IRS.

President Trump went on to direct that "Treasury was to take 'appropriate steps' to delay or suspend the effective date of the identified regulations, and to modify or rescind the regulations, through notice and comment rulemaking."

On October 4, 2017, Treasury released a final report with recommendations intended to mitigate the burden imposed by legislation identified as either imposing an undue financial burden on taxpayers or adding excessive complexity to the tax system.[3] With respect to the final report, the Treasury issued a press release stating that the proposed regulations under Section 2704 would be withdrawn because they "... would have hurt family-owned and operated businesses by limiting valuation discounts. The regulations would have made it difficult and costly for families to transfer their businesses to the next generation."[4]

Eventually, on October 20, 2017, the IRS published a withdrawal notice, eliminating the possibility of the proposed regulations being issued in temporary or final form.

What's New with the IRS? – Anecdotal Developments

The abandonment of the 2704 proposed regulations is the most recent battle on this broader issue. Since the withdrawal notice was issued, estate planning practitioners have continued to plan utilizing FLPs in a "business as usual" manner, often taking advantage of the deep valuation discounts that they provide.

However, the IRS has not given up its position on valuation discounts in the context of family-owned/controlled businesses. Anecdotal evidence from the ground level shows that IRS examiners continue to assert that the depths of the discounts ordinarily taken by taxpayers are unreasonable. Under 706 audit, estates holding ownership in FLPs that contain a preponderance of marketable securities and cash are under attack, with IRS engineers routinely asserting that little to no discount should be taken, essentially disregarding the existence of the limited partnership structure.

Examiners also continue to assert that §2036 applies to estates that have fact patterns that may be low-hanging fruit. In one recent case, a taxpayer died within 45 days of the funding of the FLP. A collective valuation discount of 36% was asserted on the Form 706, which mitigated the Estate and Generations Skipping Transfer Tax liabilities by approximately $8 million. Under examination, the IRS has asserted that, in an echo of the *Estate of Strangi*[5], the FLP should be disregarded for tax purposes and no valuation discount should be applied. In an effort to force a settlement, the examiner also threatened to assert penalties for substantial underpayment of tax and substantial valuation understatement. Notwithstanding the IRS' position in this case, there was still an offer to settle the case if the taxpayer would accept a lowered valuation discount of 15% or less.

In another recent 706 examination, the decedent placed approximately $18 million in assets into an FLP and retained her house (which was unencumbered) and $1 million in cash in her individual name. She made

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no lifetime gifts of FLP interest. The IRS examiner argued, citing the *Estate of Paxton*[6], there is an "implied understanding" that distributions from the FLP would be required to maintain the decedent's standard of living, and therefore, the decedent retained possession or enjoyment of the assets under Section 2036.

Sometimes, the IRS examiners rely on no law or legal theory at all. In one recent case, the agent simply stated that the valuation discount of 43.6% on an FLP was too high and offered to settle the estate at a lowered discount of 35%.

The anecdotal evidence suggests that when the facts of a case provide the IRS with a reasonable 2036 argument, the mandate is to press the estate to lower the discount. Further, it appears that the IRS believes that they can chip away at the depth of valuation discounts by simply injecting the fear of a long audit and appeals process.

Business as Usual

Utilizing valuation discounts of family-controlled businesses in the context of estate planning is a tax-planning strategy that has not gone away. Rather, it appears that the motivation of taxpayers to employ FLPs and other techniques to leverage valuation discounts has only picked up in the Tax Cuts and Jobs Act era of $11.4 million (in 2019) Estate and Gift Tax exemptions. However, although being all but forced to abandon the §2704 proposed regulations, the IRS continues to fight, tooth-and-nail, valuation discounts used for estate and gift tax planning purposes.

ABOUT THE AUTHOR:
Jamie T. Katzen is Senior Counsel at Gray Reed & McGraw LLP in Dallas. He has significant experience in the fields of income tax planning and estate planning, focusing his practice on the representation of business owners, professionals and executives. He advises clients on corporate structure, tax planning, asset protection, and estate and gift tax mitigation strategies. He received his B.A. in History from the University of Kansas, his J.D. from the St. Mary's School of Law and his LL.M. in Taxation from the SMU Dedman School of Law.

FOOTNOTES:

[1] See, e.g., Estate of Bongard, 124 T.C. 95 (2005); *Estate of Harper*, 83 T.C.M. (CCH) 1641, T.C. Memo. 2002-121; *Estate of Reichardt*, 114 T.C. 144, 114 T.C. No. 9 (2000).

[2] Lorenzo, "Senate GOP Urges Treasury to Abandon Estate Tax Rules," *BNA Daily Tax Report*, 189 DTR G-5 (September 29, 2016); letter reproduced in *BNA Daily Tax Report*, (September 30, 2016)

[3] See Executive Order 13789, 82 Fed. Reg. 19,317 (Apr. 26, 2017); Second Report to the President on Identifying and Reducing Tax Regulatory Burdens, Executive Order 13789 (Oct. 2, 2017), 82 Fed. Reg. 48,013 (Oct. 16, 2017).

[4] Available at https://www.treasury.gov/press-center/press-releases/Pages/sm0172.aspx.

[5] *Estate of Strangi v. Commissioner*, 293 F.3d 279

[6] *Estate of Paxton v. Commissioner*, 86 T.C. 785 (T.C. 1986)

THE SECTION 199A FINAL REGULATIONS – IMPORTANT CLARIFICATIONS, PART 2

Opportunities and Pitfalls

By Steve Beck

This article is the second of a two-part series discussing important provisions of the final regulations impacting the effect of the deduction provided under I.R.C. § 199A (the 199A deduction). The 199A deduction basically 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"). Note: The 199A deduction also allows a deduction in connection with qualified REIT dividends and qualified publicly traded partnership income. This article, however, focuses solely on the deductibility of 20% of QBI.

Final regulations were issued last year clarifying important issues regarding the applicability and effect of the 199A deduction (the 199A regulations). T.D. 9847 (February 12, 2019). The first article of this series focused 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 a prerequisite of qualifying for the 199A deduction. (See "The Section 199A Final Regulations – Important Clarifications, Part 1 - What is a Qualified Trade or Business," in the July/August 2019 issue of *Today's CPA* magazine.)

The first article focused on whether particular activities are eligible for the 199A deduction. In contrast, this second article addresses issues arising after the client's

eligibility for the 199A deduction has been established. Principally, this article discusses opportunities provided by the 199A regulations through which return preparers can help their clients maximize the amount of their 199A deductions. Additionally, this article mentions some pitfalls through which omissions by return preparers can result in reducing or eliminating the amounts of their clients' 199A deduction that otherwise would have been available.

The Wage Limitation

The 199A regulations provide opportunities for maximizing the amount of the 199A deduction under the wage limitation. As a quick recap, the amount of an individual's 199A deduction is generally equal to 20% of the aggregate amount of the individual's QBI from QTBs conducted by that individual (or an RPE in which the individual owns an interest). The amount of the 199A deduction, however, is reduced to the extent that 20% of QBI exceeds the amount allowable under the wage limitation.

The generally applicable wage limitation provides that the amount of the 199A deduction is reduced to the extent that 20% of QBI from a QTB exceeds the greater of: (a) 50% of the W-2 wages paid with respect to the QTB; or (b) the sum of: (i) 25% of the W-2 wages paid with respect to the QTB; plus (ii) 2.5% of the unadjusted basis immediately after acquisition (the UBIA) of all qualified property. I.R.C. §199A(b)(2). (The amount of W-2 wages taken into account for purposes of the 199A deduction is hereafter referred to as "W-2 wages.")

This generally applicable limitation is hereafter referred to as the "wage limitation" and it applies to individuals who: (i) are not engaged in a specified service trade or business (SSTB); and (ii) have an amount of taxable income of at least $207,500 (or $415,000 for married filing joint taxpayers, such amount, the "phase-out amount"). For individuals with taxable income less than the phase-out amount, a modified version of the wage limitation may apply. I.R.C. § 199A(b)(3)(B)(i).

General Rule – 199A Deduction Attributes Must be Calculated Separately for Each QTB

Thus, to calculate the amount of the 199A deduction available following application of the wage limitation, it is necessary to calculate that individual's share of QBI, W-2 wages and UBIA in connection with all of the QTBs conducted by that individual (or by an RPE in which that individual owns an interest).

The 199A regulations provide that the amount of an individual's or RPE's QBI generally must be calculated separately for each QTB conducted directly by that individual or RPE. Treas. Reg. § 1.199A-3(a). Similarly, the amount of W-2 wages and UBIA must be calculated separately for each QTB in which the individual or RPE is directly engaged. Treas. Reg. § 1.199A-2(a)(2), (3).

Aggregation – An Opportunity for Managing the Wage Limitation

Although individuals and RPEs are generally required to calculate their QBI, W-2 wages and UBIA separately for each QTB, the 199A regulations provide rules that permit individuals and RPEs to aggregate QTBs and treat the aggregate as a single QTB for purposes of applying the wage limitation. Treas. Reg. § 1.199A-4(b)(2). If an individual or RPE chooses to aggregate multiple QTBs, the QBI, W-2 wages and UBIA of those QTBs must be combined for purposes of applying the wage limitation. Id.

There are five requirements that must be satisfied to aggregate QTBs under the 199A regulations.

The aggregation rules in the 199A regulations are permissive. No individual or RPE is required to aggregate if they do not wish to do so. Treas. Reg. § 1.199A-4(a).

There are limits, however, to the extent to which QTBs can be aggregated under the 199A regulations. There are five requirements that must be satisfied in order to aggregate QTBs. If the requirements are satisfied, individuals and RPEs may aggregate (or not) to whatever extent they desire within the scope of those regulatory requirements. Id.

The five requirements (the aggregation requirements) that must be satisfied to aggregate QTBs under the 199A regulations are as follows. Treas. Reg. § 1.199A-4(b)(1).

First, the same person or group of persons must own, directly or indirectly, 50% or more of each QTB to be aggregated (the ownership requirement). Treas. Reg. § 1.199A-4(b)(1)(i). In the case of QTBs conducted by an S Corporation, the same person or group of persons must own at least 50% of the issued and outstanding shares of that S Corporation in order to aggregate those QTBs. Id.

In the case of QTBs conducted by a partnership, the same person or group of persons must own at least 50% of the capital or profits of the partnership. Id. For purposes of determining whether the same person or group of persons owns at least 50% of the QTB, an individual or RPE is attributed ownership from other related persons

under the standards of I.R.C. §§ 267(b) and 707(b). Treas. Reg. § 1.199A-4(b)(1)(i).

Second, the ownership requirement must be satisfied for a majority of the tax year, including the last day of the tax year, in which the items attributable to each QBT to be aggregated are included in income. Treas. Reg. § 1.199A-4(b)(1)(ii).

Third, all of the items attributable to each QTB to be aggregated must be reported on tax returns with the same tax year, not taking into account short tax years. Treas. Reg. § 1.199A-4(b)(1)(iii).

Fourth, none of the businesses to be aggregated may be an SSTB. Treas. Reg. § 1.199A-4(b)(1)(iv).

Lastly, the QTBs to be aggregated must satisfy at least two of the following factors, based on all the facts and circumstances. Treas. Reg § 1.199A-4(b)(1)(v). The first factor is satisfied if the QTBs provide products and services that are the same or customarily offered together (the similarity factor). Treas. Reg. § 1.199A-4(b)(1)(v)(A). The second factor is satisfied if the QTBs share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources or information technology resources (the sharing factor). The third factor is satisfied if the QTBs are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group; for example, supply chain interdependencies (the interdependency factor).

An individual may aggregate QTBs operated directly or through an RPE to the extent an aggregation is not inconsistent with the aggregation of an RPE. Treas. Reg. § 1.199A-4(b)(2)(i). Thus, if an RPE aggregates its QTBs, an individual owner of that RPE cannot segregate a QTB from those aggregated by the RPE. Id. An individual, however, may aggregate additional QTBs to those aggregated by the RPE as long as the aggregation requirements are otherwise satisfied. Id.

Similar rules apply to an RPE's ability to aggregate or segregate QTBs conducted by a lower-tier RPE. Treas. Reg. § 1.199A-4(b)(2)(ii). In addition, if the RPE chooses not to aggregate its QTBs, its owners are not required to follow the same methodology and can separately choose whether to aggregate their allocable shares of those QTBs conducted by the RPE. Id. If, however, an RPE chooses to aggregate multiple QTBs, that RPE must compute and report the QBI, W-2 wages and UBIA for the aggregated QTBs to its owners. Id.

The examples in Exhibits 1 and 2, adapted from the 199A regulations, illustrate the potential flexibility and restrictions posed by the aggregation requirements. In addition, the potential benefit of utilizing aggregation to increase the amount of the 199A deduction available under the wage limitation is illustrated by the examples in Exhibits 3 and 4, which are also adapted from the 199A regulations.

Exhibit 1: Example Based on Treas. Reg. § 1.199A-4(d)(8)

Gail owns 80% of the stock in S1, an S Corporation, and 80% of the capital and profits in LLC1 and LLC2, each of which is a partnership for federal tax purposes. LLC1 manufactures and supplies all of the widgets sold by LLC2. LLC2 operates a retail store that sells LLC1's widgets. S1 owns the real property leased to LLC1 and LLC2 for use by the factory and retail store. All of the entities share common advertising and management.

Gail owns more than 50% of the stock of S1 and more than 50% of the capital and profits in LLC1 and LLC2, and she, therefore, satisfies the ownership requirement. LLC1, LLC2 and S1 share significant centralized business elements and thus satisfy the sharing factor. LLC1, LLC2 and S1 are operated in coordination with, or in reliance upon, one or more of the businesses in the aggregated group and thus satisfy the interdependency factor. Thus, Gail can treat the business operations of LLC1 and LLC2 as a single QTB for purposes of applying I.R.C. § 199A.

In addition, S1 is eligible to be included in the aggregated group, because it leases property to a QTB within the aggregated QTB and thus qualifies as a trade or business for purposes of the 199A deduction under the special rule of Treas. Reg. § 1.199A-1(b)(14) (discussed in the first article in this series).

Exhibit 2: Example Based on Treas. Reg. § 1.199A-4(d)(11)

Harvey, Joan, Kyle and Louise own interests in PRS1 and PRS2, each a partnership, and S1 and S2, each an S Corporation. Harvey owns 30%, Joan owns 20%, Kyle owns 5% and Louise owns 45% of each of the five entities. All of the entities satisfy two of the similarity, sharing and interdependency factors. For purposes of the 199A deduction, the taxpayers report the following aggregated QTBs:

- Harvey aggregates PRS1 and S1 together and aggregates PRS2 and S2 together;
- Joan aggregates PRS1, S1 and S2 together and reports PRS2 separately;
- Kyle aggregates PRS1 and PRS2 together and aggregates S1 and S2 together; and
- Louise aggregates S1, S2 and PRS2 together and reports PRS1 separately.

Harvey, Joan, Kyle and Louise together own a majority interest in PRS1, PRS2, S1 and S2, and they, therefore, satisfy the ownership requirement. In addition, each of the entities satisfies two of the similarity, sharing and interdependency factors. As a result, Harvey, Joan, Kyle and Louise are permitted to aggregate the QTBs of all the entities for purposes of calculating their 199A deductions.

Notably, each of the aggregation methods chosen by Harvey, Joan, Kyle and Louise are permitted, notwithstanding that they each opted to aggregate in a different manner. Thus, as shown in this example, owners of RPEs have extensive flexibility in determining their aggregation method and are not bound by the methods of other owners.

Exhibit 3: Example of Separate Calculation of 199A Attributes (Based on Treas. Reg. § 1.199A-1(d)(4)(vii)

Frida, an unmarried individual, owns as a sole proprietor 100% of three QTBs, Business X, Business Y and Business Z. None of the QTBs have any UBIA. Frida does not aggregate the QTBs for purposes of the 199A deduction.

For 2018, Business X generates $1 million of QBI and pays $500,000 of W-2 wages. Business Y also generates $1 million of QBI but pays no W-2 wages. Business Z generates $2,000 of QBI and pays $500,000 of W-2 wages.

Frida also has $750,000 of wage income from employment with an unrelated company. After allowable deductions unrelated to the businesses, Frida's taxable income is $2,722,000. Because Frida's taxable income is above the phase-out amount, Frida's 199A deduction is subject to the wage limitation.

Frida did not aggregate her QTBs and thus the wage limitation must be applied separately to each QTB. None of the QTBs hold qualified property and, therefore, only the 50% of W-2 wages must be calculated.

Accordingly, Frida applies the wage limitation by determining the lesser of 20% of QBI and 50% of W-2 wages for each QTB. For Business X, the lesser of 20% of QBI ($1,000,000 x 20 percent = $200,000) and 50% of Business X's W-2 wages ($500,000 x 50% = $250,000) is $200,000. Business Y pays no W-2 wages. Thus, the lesser of 20% of Business Y's QBI ($1,000,000 x 20% = $200,000) and 50% of its W-2 wages (zero) is zero. For Business Z, the lesser of 20% of QBI ($2,000 x 20% = $400) and 50% of W-2 wages ($500,000 x 50% = $250,000) is $400. Thus, the total of the combined amounts available under the wage limitation for inclusion in the 199A deduction is $200,400 ($200,000 + 0 + 400).

Exhibit 4: Example Based on Treas. Reg. § 1.199A-1(d)(4)(viii)

This example assumes the same facts as in Exhibit 3, except that Frida aggregates Business X, Business Y and Business Z. Because Frida's taxable income is above the phase-out amount, Frida's 199A deduction is subject to the wage limitation. Because the QTBs are aggregated, the wage limitation is applied on an aggregated basis. None of the QTBs hold qualified property. Therefore, only 50% of the W-2 wages must be calculated. Frida applies the wage limitation by determining the lesser of: 20% of the QBI from the aggregated QTBs, which is $400,400 ($2,002,000 x 20%) and 50% of W-2 wages from the aggregated QTBs, which is $500,000 ($1,000,000 x 50%). Thus, the combined amount available under the wage limitation for inclusion in the 199A deduction is $400,400.

The examples in Exhibits 3 and 4 illustrate that, under the same facts, aggregation enabled Frida to virtually double the amount of her 199A deduction. This was because aggregation enabled her to devote excess available W-2 wages, primarily from Business Z, to enable QBI from the other QTBs to be available for the 199A deduction.

Aggregation - Potential Pitfalls Under the 199A Regulations

Aggregation, however, has its potential drawbacks. An aggregation method, once chosen, is generally binding on all subsequent years. Specifically, the 199A regulations provide that, once an individual or RPE chooses to aggregate two or more QTBs, the individual or RPE generally must report the aggregated QTBs consistently in all subsequent tax years. Treas. Reg. §§ 1.199A-4(c)(1), (3).

There are, however, limited exceptions through which an aggregation method may be modified. For example, an individual or RPE may add a newly created or newly acquired QTB to an existing aggregated QTB if the aggregation requirements are otherwise satisfied. Id. In addition, after choosing an aggregation method, if there is a significant change in facts and circumstances in a subsequent year such that the previously chosen method no longer satisfies the aggregation requirements, the

QTBs are no longer aggregated and the individual or RPE must reapply the aggregation requirements to determine a new permissible aggregation method. Id.

As a result of the binding nature of an aggregation method, taxpayers and their advisors need to consider carefully the long-term implications of a potential aggregation method. The methodology that may be advantageous in the first year may not continue to be optimal in the future.

Payroll Companies - An Alternative Potential Strategy for Managing the Wage Limitation

The 199A regulations contain a special rule through which a taxpayer's W-2 wages may also include wages actually paid by another person in certain circumstances. Specifically, in determining W-2 wages, an individual or RPE may take into account any wages paid by another person (the payroll company) and reported by that payroll company on Forms W-2 with the payroll company listed as employer in Box C of those Forms W-2, provided that the wages were paid to common law employees or officers of the individual or RPE for employment by the individual or RPE. Treas. Reg. § 1.199A-2(b)(2)(ii).

In this situation, the payroll company paying the W-2 wages and reporting the W-2 wages on Forms W-2 is precluded from taking into account such wages for purposes of determining the amount of the payroll company's W-2 wages. For purposes of this rule, a payroll company that can pay and report W-2 wages on behalf of, or with respect to, others can include, but are not limited to, certified professional employer organizations under I.R.C. § 7705, statutory employers under I.R.C. § 3401(d)(1) and agents under I.R.C. § 3504.

The use of a payroll company by commonly owned QTBs may enable the owners to allocate the W-2 wages where needed to maximize the amount of the 199A deduction available under the wage limitation. The payroll company can provide the workers to perform services on behalf of the affiliated QTBs. Each year, the services of those workers can be allocated among those affiliated QTBs and they can reimburse the payroll company for their proportionate shares of the wages paid to the workers.

In this manner, the reimbursing QTB can get credit for the W-2 wages paid for the services allocated to that QTB. Of course, the workers' services and W-2 wages should be allocated among the affiliated QTBs consistently with how those QTBs' truly benefitted from those services.

The methodology that may be advantageous in the first year may not continue to be optimal in the future.

Significantly, it may be possible to allocate the services differently among the affiliated QTBs' on a year-to-year basis if the manner in which the workers' services benefit the QTBs' changes on a yearly basis. In contrast, an aggregation method, once chosen, is binding on the taxpayer for all future years. Thus, the payroll company may provide affiliated QTBs with flexibility to manage the wage limitation in a manner not afforded by the aggregation method.

Additional Pitfalls Under the 199A Regulations

The 199A regulations impose annual disclosure requirements on individuals and RPEs in connection with their chosen method of aggregation. Individuals, for each tax year, must attach a statement to their returns identifying each business aggregated for purposes of I.R.C. § 199A. Treas. Reg. § 1.199A-4(c)(2)(i). The statement must contain:

- A description of each business;
- The name and EIN of each entity in which a business is operated;
- Information identifying any business that was formed, ceased operations, was acquired, or was disposed of during the tax year;
- Information identifying any aggregated business of an RPE in which the individual holds an ownership interest; and
- Such other information as the IRS Commissioner may require in forms, instructions or other published guidance. Id.

Additionally, RPEs must disclose similar information on the Schedules K-1 issued to their owners with regard to the RPE's chosen aggregation method. Treas. Reg. § 1.199A-4(c)(4)(i).

Significantly, if an individual or RPE fails to attach the required disclosure statement to the tax return or Schedule K-1, the IRS Commissioner may disaggregate the individual's or RPE's QTBs. Treas. Reg. § 1.199A-4(c)(2)(ii), (4)(ii). If the Commissioner disaggregates the individual's or RPE's QTBs, the individual or RPE cannot aggregate them for the subsequent three tax years. Id.

The 199A regulations also impose additional reporting requirements on RPEs. An RPE must separately identify and report on the Schedule K-1 issued to its owners for any business engaged in directly by the RPE: each owner's allocable share of QBI, W-2 wages and UBIA attributable to each such business, and whether any business of the RPE is an SSTB. Treas. Reg. § 1.199A-6(b)(3)(i). Further, an RPE must report on an attachment to the Schedule K-1, any QBI, W-2 wages, UBIA or SSTB determinations reported to it by any lower-tier RPE in which the RPE owns a direct or indirect interest. Treas. Reg. § 1.199A-6(b)(3)(ii).

The consequences of an RPE's failure to comply with these reporting requirements may be dire for its owners. If an RPE fails to separately identify or report on the Schedule K-1 (or any attachments thereto) issued to an owner any of the items required to be so reported, the owner's share (and the share of any upper-tier indirect owner) of the unreported item will be presumed to be zero. Treas. Reg. § 1.199A-6(b)(3)(iii).

Helpful Guidance and Potential Traps

The 199A regulations provide helpful guidance that is taxpayer beneficial. By introducing the aggregation and payroll company concepts, the 199A regulations provide taxpayers and their advisors helpful tools for maximizing the 199A deduction available under the wage limitation.

The 199A regulations, however, also provide potential traps for the unwary. The binding nature of the aggregation method chosen may result in a taxpayer being saddled with an unfavorable methodology if not initially chosen carefully.

In addition, an RPE's failure to disclose 199A attributes to an owner may eliminate that owner's ability to qualify for a 199A deduction that otherwise would have been available. For these reasons, the 199A regulations heighten the potential risk and reward for professionals advising their clients in connection with the 199A deduction.

ABOUT THE AUTHOR:
Steve Beck is a partner with Meadows Collier in Dallas. He is a board-certified tax attorney who practices in the areas of income tax and business planning, corporate, state tax planning and litigation, and real estate. You can reach him by phone at 214-744-3700 or by email at sbeck@meadowscollier.com.

BE PREPARED FOR THE NEW AUDITOR REPORTING STANDARDS

By Steve Grice, Ph.D., CPA, and Amanda N. Paul, CPA

CURRICULUM: Accounting and Auditing

LEVEL: Basic

DESIGNED FOR: Auditors and Auditing Practitioners

OBJECTIVES: To highlight some of the significant changes to the auditor's reporting requirements to help practitioners prepare for implementation of Statement on Auditing Standards No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*

KEY TOPICS: Re-ordering of the auditor's report sections, terminology and content changes, key audit matters, types of modified opinions, and going concern guidance

PREREQUISITES: None

ADVANCED PREPARATION: None

In May 2019, the Auditing Standards Board (ASB) ushered in new auditor reporting standards with the issuance of Statement on Auditing Standards No. 134 titled, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements* (SAS 134). The ASB's objective with this new guidance is to converge the U.S. reporting standards with those issued by the International Auditing and Assurance Standards Board (IAASB).

SAS 134 supersedes AU-C Sections 700 titled, *Forming an Opinion and Reporting on Financial Statements*, 705 titled, *Modifications to the Opinion in the Independent Auditor's Report*, and 706 titled, *Emphasis-of-Matter Paragraphs and other-Matter Paragraphs in the Independent Auditor's Report*. (Note: These superceded sections are retained in the Auditing Standards Codification and are identified as AU-C Sections 700A, 705A and 706A).

In addition, the new guidance introduces reporting requirements related to key audit matters (KAM) for private companies in AU-C Section 701 titled, *Communicating Key Audit Matters in the Independent Auditor's Report*. The provisions of SAS 134 are effective for audits of financial statements for periods ending on or after December 15, 2020. The ASB prohibits early application. The purpose of this article is to highlight some of the significant changes to the auditor's reporting requirements to help practitioners prepare for the implementation.

Report Sections Re-Ordered

Though the information in the audit report remains mostly unchanged, one of the more noticeable requirements in the new guidance is the re-ordering of the auditor's report sections. Exhibit

Exhibit 1: Pre- and Post-SAS 134 Audit Report Sections

Order	Pre-SAS 134 Sections	Post-SAS 134 Sections
1st	Introductory Paragraph	Opinion
2nd	Management's Responsibility for the Financial Statements	Basis for Opinion
3rd	Auditor's Responsibility	Responsibilities of Management for the Financial Statements
4th	Opinion	Auditor's Responsibilities for the Audit of the Financial Statements

1 compares the basic audit report sections in the pre-SAS 134 guidance to those in the post-SAS 134 guidance.

The illustrative auditor's reports shown in Exhibits 2 and 3 are prepared using the pre- and post-SAS 134 guidance to demonstrate the changes in the standards. A comparison of these reports highlights the re-ordered sections of the auditor's report required by the new auditor reporting standards.

The most significant change relates to the movement of the auditor's "Opinion" section from the last section to the first section in the report. In addition, the reporting standards now require the addition of a "Basis of Opinion" section following the "Opinion" section. The illustrative auditor's reports in the exhibits are based on the audit of comparative financial statements prepared in accordance with accounting principles generally accepted in the United States of America. In these illustrations, the auditor has not been engaged to communicate KAM (which will be discussed later).

Terminology and Content Changes

Practitioners should be aware of changes in the terminology and content within each section of the auditor's report. Though the information presented in the pre- and post-SAS 134 reports is similar, the placement of that information across the report sections is changed. The "Opinion" section now includes the information that was previously in the "Introductory" paragraph of the pre-SAS 134 report. The "Auditor's Responsibility" section of the pre-SAS 134 report includes (1) a statement that the audit was conducted in accordance with auditing standards generally accepted in the United States of America and (2) a statement about whether the auditor believes that the audit evidence the auditor obtained is sufficient and appropriate to provide a basis for the auditor's opinion. These statements are included in the "Basis of Opinion" section of the post-SAS 134 report.

The "Management's Responsibility for the Financial Statements" header is changed to "Responsibilities of Management for the Financial Statements" as required by paragraph .31 of AU-C Section 700. In addition, the "Responsibilities of Management for the Financial Statements" section in the post-SAS 134 reports includes a statement related to management's requirement to perform a going concern evaluation. The pre-SAS 134 report did not include a statement related to management's going concern evaluation.

Also, the "Auditor's Responsibility" header is changed to "Auditor's Responsibilities for the Audit of the Financial Statements" as required by paragraph .34 of AU-C Section 700. Practitioners should note the expanded wording in this section and the required listing of the auditor's requirements in a financial statement audit. For example, auditors are now required to include a statement related to the required communications with those charged with governance on certain matters identified during the audit.

To ensure compliance with the new auditor's report terminology and section content, auditors should ensure their report templates are updated for the changes ushered in by SAS 134.

Key Audit Matters

Paragraph .07 of AU-C Section 701 defines KAM as "those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. KAM are selected from matters communicated with those charged with governance." AU-C Section 260, titled *The Auditor's Communication with Those Charged with Governance*, identifies the following matters that should be communicated with those charged with governance and, thus, are potential KAM:

- The auditor's responsibilities with regard to the financial statement audit.
- Planned scope and timing of the audit.
- Significant findings or issues from the audit.
- Uncorrected misstatements.
- Material, corrected misstatements that were brought to the attention of management as a result of audit procedures.

Exhibit 2: Pre-SAS 134 Auditor Report

Independent Auditor's Report

President
Alpha Company
Pike, Alabama

We have audited the accompanying consolidated financial statements of Alpha Company, which comprise the balance sheets as of December 31, 2018 and 2019, and the related statements of income, changes in stockholders' equity and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements
Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America. This includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility
Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used, and the reasonableness of, significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion
In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Alpha Company as of December 31, 2018 and 2019, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Omega, CPAs
Troy, Alabama
January 15, 2020

Exhibit 3: Post-SAS 134 Auditor Report

Independent Auditor's Report

President
Alpha Company
Pike, Alabama

Opinion
We have audited the financial statements of Alpha Company, which comprise the balance sheets as of December 31, 2020 and 2019, and the related statements of income, changes in stockholders' equity and cash flows for the years then ended, and the related notes to the financial statements.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of Alpha Company as of December 31, 2020 and 2019, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Basis for Opinion
We conducted our audits in accordance with auditing standards generally accepted in the United States of America (GAAS). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of Alpha Company and to meet our other ethical responsibilities in accordance with the relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

(Insert "Key Audit Matters" section here when engaged to communicate KAM)

Responsibilities of Management for the Financial Statements
Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about Alpha Company's ability to continue as a going concern within one year from the date the financial statements are issued.

Auditor's Responsibilities for the Audit of the Financial Statements
Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not absolute assurance and, therefore, is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations or the override of internal control. Misstatements are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users made on the basis of these financial statements.

In performing an audit in accordance with GAAS, we:
- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
- Obtain an understanding of internal control relevant to the audit to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of Alpha Company's internal control. Accordingly, no such opinion is expressed.
- Evaluate the appropriateness of accounting policies used, and the reasonableness of, significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.
- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about Alpha Company's ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings and certain internal control-related matters that we identified during the audit.

Omega, CPAs
Troy, Alabama
January 15, 2021

- Significant findings or issues, if any, arising from the audit that were discussed, or the subject of correspondence, with management.
- The auditor's views about significant matters that were the subject of management's consultations with other accountants on accounting or auditing matters when the auditor is aware that such consultation has occurred.
- Written representations the auditor is requesting.

Prior to the issuance of SAS 134, there was no reporting guidance related to the communication of KAM for private companies. Pursuant to the new reporting guidance in AU-C Section 701, auditors are only required to communicate KAM in the audit report when they are engaged to do so.

Exhibit 4: KAM Report Section

Key Audit Matters

Key audit matters are those matters that were communicated with those charged with governance and, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Hedge Accounting: The Company reports net derivative financial assets at fair value of $100,000 and net derivative financial liabilities at fair value of $50,000 as of December 31,2020. Derivative financial instruments are used to manage and hedge commodity price risks, foreign currency exchange risks and interest rate risks. These instruments are typically designated in a fair value or cash flow hedge relationship. Financial instruments that are not designated in a hedging relationship, and where no hedge accounting is applied, are measured at fair value. The fair value of the derivative financial instruments is based on quoted prices in active markets or on valuation models using observable input data. We focused on this because of the number of contracts, their measurement and the complexity related to hedge accounting.

We performed the following audit procedures related to this matter:
- Obtained an understanding of the risk management policies and tested key controls for the use, the recognition and the measurement of derivative financial instruments.
- Reconciled derivative financial instruments data to third party confirmations.
- Compared input data used in the valuation models to independent sources and external market data.
- Compared valuation of derivative financial instruments with market data and with results from alternative, independent valuation models.
- Tested the applicability and accuracy of hedge accounting.
- Considered the appropriateness of disclosures in relation to financial risk management, derivative financial instruments and hedge accounting.

When the auditor is engaged to communicate KAM, the auditor's report should include a "Key Audit Matters" section. The exhibit in paragraph .A81 of AU-C 700 places the "Key Audit Matters" section immediately following the "Basis for Opinion" section. Paragraph .A31 of AU-C Section 700 states that placing the "Key Audit Matters" section in close proximity to the "Opinion" and "Basis of Opinion" sections may give prominence to the information.

In general, the guidance stipulates that the description of the KAM should address why the matter was considered significant to the audit, as well as how the matter was addressed in the audit. Exhibit 4 provides an example of the "Key Audit Matter" section in the auditor's report.

When the auditor determines that there are no KAM to communicate, paragraph .15 in AU-C Section 701 indicates that the auditor should include a statement to this effect in the "Key Audit Matters" section. In some instances, the KAM may give rise to a qualified opinion. In these instances, paragraph .14 in AU-C Section 701 states that the auditor should not describe these KAM in the "Key Audit Matters" section, but rather, include a reference to the "Basis for Qualified Opinion" section.

In addition, there may be engagements where the auditor's conclusion is that there is substantial doubt about the entity's ability to continue as a going concern. The guidance indicates that the auditor should not describe the matters associated with the going concern issue in the "Key Audit Matters" section, but rather, include a reference to the "Substantial Doubt About the Entity's Ability to Continue as a Going Concern" section. It should be noted that paragraph .30 in AU-C Section 705 indicates that the auditor is prohibited from including a KAM section in the report when the auditor issues an adverse opinion or disclaims an opinion.

Modified Opinions

The provisions of SAS 134 did not change the types of modified opinions. The three types of modified opinions continue to be (1) qualified opinion, (2) adverse opinion and (3) disclaimer of opinion. However, practitioners should be aware of the modifications to both the "Opinion" and "Basis of Opinion" section headings when issuing a modified opinion. Exhibit 5 illustrates the change in section headings for the auditor's report containing a modified opinion.

Importantly, there were no significant changes to the guidance related to when a modified opinion is appropriate. This determination continues to focus on

Exhibit 5: Section Headings for Modified Opinions

Opinion Type	"Opinion" Section Heading	"Basis of Opinion" Section Heading
Unmodified	"Opinion"	"Basis of Opinion"
Qualified	"Qualified Opinion"	"Basis for Qualified Opinion"
Adverse	"Adverse Opinion"	"Basis of Adverse Opinion"
Disclaimer	"Disclaimer of Opinion"	"Basis for Disclaimer of Opinion"

the materiality and the pervasiveness of a departure from the applicable financial reporting framework (e.g., GAAP) or a scope limitation. For example, the auditor should express a qualified opinion when a GAAP departure is deemed to be material, but not pervasive, to the financial statements.

Emphasis-of-Matter and Other-Matter Paragraph

Prior to SAS 134, the guidance specified the placement of an emphasis-of-matter (EOM) and an other-matter (OM) paragraph within the auditor's report. For example, the prior guidance stipulated that the EOM should immediately follow the opinion paragraph in the report. The new auditor reporting standards in SAS 134 do not stipulate the placement of the EOM or OM paragraph in the auditor's report. Instead, paragraph .A14 of AU-C 706 indicates that the placement of an EOM or OM paragraph depends on the nature of the information being communicated and the auditor's judgment of the significance of the information to the financial statement users.

The guidance also identifies situations in which the use of an EOM paragraph is not acceptable. Paragraph .08 of AU-C Section 706 makes clear that the use of an EOM paragraph is not a substitute for disclosing matters that would otherwise require the auditor's report to be modified. That is, the auditor should follow the guidance in AU-C Section 705 when the matter gives rise to a modified opinion.

Also, Paragraph .A1 of AU-C Section 706 states that an EOM paragraph should not be used as a substitute to provide the description of KAM. That is, the KAM should be described in the "Key Audit Matters" section of the auditor's report, not in an EOM paragraph.

Going Concern Guidance

SAS 134 provides additional guidance related to reporting when auditors encounter going concern issues in the engagement. Prior to the issuance of SAS 134, AU-C Section 570, titled *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, required auditors to include an EOM paragraph in the report when there was substantial doubt about the entity's ability to continue as a going concern.

The SAS 134 amendments to AU-C Section 570 eliminated the requirement to use an EOM paragraph for going concern reporting. Specifically, paragraph .24 of AU-C Section 570 was amended to state that a separate section should be added to the auditor's report with the heading "Substantial Doubt About the Entity's Ability to Continue as a Going Concern" when the auditor concludes that there is substantial doubt about the entity's ability to continue as a going concern. However, paragraph .A2 of AU-C Section 706 indicates that the auditor may elect to use an EOM paragraph when the substantial doubt was alleviated by management's plan and the financial statement disclosures are adequate.

Preparing for the New Standards

It is imperative that practitioners begin to prepare for the significant changes in the new auditor reporting standards. The enhanced auditor's report, KAM communication requirements and other amendments should be applied to calendar year-end December 31, 2020 audit engagements. Hopefully, the highlights covered in this article provide practitioners with helpful information as they prepare to implement the new auditor reporting standards.

ABOUT THE AUTHORS:
Steve Grice, Ph.D., CPA, is the Director of the School of Accountancy at Troy University. Contact him at sgrice@troy.edu.

Amanda N. Paul, CPA, is Assistant Professor of Accountancy at Troy University.

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CPE ARTICLE: BE PREPARED FOR THE NEW AUDITOR REPORTING STANDARDS

By Steve Grice, Ph.D., CPA, and Amanda Paul, CPA

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. The new auditor reporting standards require that the "Opinion" section of the auditor's report be presented as the:
A. Fourth section
B. Third section
C. Second section
D. First section

2. According to SAS No. 134, which section is required to follow the "Opinion" section in the new auditor's report?
A. Key Audit Matters section
B. Basis of Opinion section
C. Responsibilities of Management for the Financial Statements
D. Auditor's Responsibilities for the Audit of the Financial Statements

3. Pursuant to the new reporting guidance in AU-C Section 701, auditors are required to communicate key audit matters (KAM) in the auditor's report:
A. For all audit engagements
B. When three or more KAM exist
C. When they are engaged to do so
D. For audit engagements involving regulated industries only

4. When engaged to communicate KAM, the auditor should:
A. Communicate the KAM in a footnote only
B. Include a separate section in the auditor's report to communicate the KAM
C. Communicate the KAM within the "Basis of Opinion" section of the auditor's report
D. Never include the matters communicated to those charged with governance as KAM

5. The new auditor reporting standards in SAS 134 are effective for audits of financial statements for periods ending on or after:
A. December 15, 2020
B. December 15, 2021
C. September 15, 2020
D. September 15, 2021

6. Which of the following is a true statement?
A. The provisions of SAS No. 134 do not change the order of the sections in the auditor's report
B. The new auditor reporting standards prohibit the auditor from communicating key audit matters in the auditor's report
C. The new auditor reporting standards in SAS No. 134 do not apply to audits of nonpublic entities
D. The provisions of SAS No. 134 do not change the types of modified opinions

7. When the auditor determines that there are no KAM to communicate, the auditor's report should:
A. Include a statement to this effect in the "Key Audit Matters" section
B. Include a statement to this effect in the "Basis of Opinion" section
C. Include a statement to this effect in the "Opinion" section
D. Not include a statement to this effect in the "Key Audit Matters" section

8. The types of modified opinions pursuant to the provisions of SAS 134 are:
A. Qualified opinion and adverse opinion only
B. Qualified opinion, adverse opinion and disclaimer of opinion
C. Qualified opinion only
D. Qualified opinion and disclaimer of opinion only

9. Which of the following statements is true?
A. Prior to SAS 134, the guidance did not specify the placement of an emphasis-of-matter and other-matter paragraph within the auditor's report
B. The new auditor reporting guidance eliminated the use of an other-matter paragraph
C. The new auditor reporting standards in SAS 134 do not stipulate the placement of the emphasis-of-matter paragraph or the other-matter paragraph in the auditor's report
D. The new auditor reporting guidance eliminated the use of an emphasis-of-matter paragraph

10. The SAS 134 guidance related to going concern reporting:
A. Never requires a separate section to be added to the auditor's report related to the going concern issue
B. Requires the auditor to use an other-matter paragraph when reporting a going concern issue
C. Eliminated the requirement to use an emphasis-of-matter paragraph for going concern reporting
D. Eliminated the auditor's requirement to consider going concern issues in an audit

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$825,000 gross. N. Houston area CPA firm. Tax 48%, bkkpg 38%, consulting 14%, trained staff, sophisticated business clientele, turn-key office, prime location. TXS1241

$67,000 gross. Mid Valley area tax and accounting firm. Bkkpg 72%, tax 28%, friendly client base, turn-key office in ideal location, seller available for transition help. TXS1244

$350,000 gross. W. Houston CPA firm. Prime location, great mix of tax, bkkpg and acctng services, staff in place and seller available to assist with transition. TXS1245

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