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"TXCPA is committed to bringing you resources, information, and connections to help you position your business and your clients for great success in 2024.

Looking Ahead to 2024

Happy New Year! We hope you had a healthy and prosperous 2023, and we look forward to helping you reach your goals in 2024!

Advances in technology, transformation of business models, challenges recruiting and retaining staff, and regulatory changes will all continue to impact your profession in the new year. TXCPA is committed to bringing you resources, information, and connections to help you position your business and your clients for great success in 2024.

Chair Tim Pike will be sharing professional issues updates in many of our chapters this month and we'll host our next free professional issues update webcast, exclusively for TXCPA members, on February 7, with a replay on February 21.

Our online member forum, [TXCPA Exchange], is hosting active and engaging conversations and the sharing of quick advice and guidance within our community of 28,000 members. I hope you'll take a moment to participate in these opportunities to take advantage of the support and information available to you.

Thank you for trusting TXCPA to be your professional community and best wishes as you venture into the new year!

Jodi Ann Ray, CAE
TXCPA President & CEO

How can we help?

I'd love to hear your feedback and answer your questions. Drop me a note at jray@tx.cpa or connect with me on LinkedIn.

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TXCPA

Artificial Intelligence Offers Turbo-Charged Solutions While Raising Concerns Regarding Security and Professional Integrity

Artificial Intelligence (AI) has emerged as a hot topic in recent months and will likely continue to be front and center as 2024 unfolds. Government at all levels are struggling to determine both how and to what extent AI needs to be regulated and what impact such regulation may impact competition if not enforced uniformly.

The awareness of AI's potential benefits and threats has intensified with the emergence of Generative Pre-trained Transformer (ChatGPT). Developed by OpenAI and initially released in late 2022, ChatGPT has accelerated the discussion regarding the opportunities and concerns raised by AI. Although its basic function is to replicate human conversation in both oral and written form, it can also generate code and even debug programming.

The business world in general and the accounting profession specifically is front and center when it comes to exploiting this emerging advancement in technology. AI is increasingly being employed to automate business processes that prior generations of technology could not address.

Applications range from the sales cycle to account reconciliations. In addition, the forecasting of budget items and predictions of market variables are increasingly relying on the power of AI.

In the continuing pursuit of efficiencies and new opportunities, both industry and service firms are eagerly exploring the potential of AI. Developing AI applications will require significant capital investment and not be without risks. Only time will tell which applications will yield the intended benefits. The public firms are in many ways at the forefront of the effort to develop the technology.

DON CARPENTER, MSACC/CPA, is clinical professor of accounting at Baylor University. Contact him at Don_Carpenter@baylor.edu.

In late 2023, EY announced that it was debuting EY.ai., a technology platform resulting from a $1.4 billion investment. As part of its development program, EY partnered with Microsoft and separately with Dell Technologies to develop AI-based applications for its business and to assist clients with theirs.

The platform has embedded AI into existing technologies such as a chatbot that responds to employee payroll questions and AI tools to aid assurance teams in assessing risk. In addition, AI enhancements have been made to EY Fabric, a proprietary platform to assist clients with AI implementation.

EY is not alone in embracing AI as the profession becomes ever more technologically driven. It is estimated that the Big Four have invested over $9 billion to date in AI driven technology. PwC has implemented an AI-based system known as GL.ai to analyze documents and prepare reports. KPMG has invested in predictive tools and document readers.

An article by Deloitte may best outline how to categorize this massive investment:

- Product: AI embedded into a product

> The short-term impact of AI depends on who controls it; the long-term impact depends on whether it can be controlled at all.
>
> —Stephen Hawking

KEY TERMS:

ARTIFICIAL INTELLIGENCE

AI APPLICATIONS

CHATGPT

or service to provide enhance customer benefits;

- Process: AI technology to streamline workflow and increase productivity;
- Insight: AI designed to aid decision-making such as forecasting and budgeting.

AI applications are not limited to the Big Four but also offer valuable tools for businesses as well. Due to its ability to process vast amounts of data and improve its effectiveness through continuous iterations, it can be of great use in predictive analysis and forecasting. It may prove useful in analytical applications such as impairment analysis or purchase price allocations.

AI can also make detection of exceptions or anomalies quicker and more accurate, enhancing internal controls. It may eliminate the need to rely on samples but instead review an entire data set, potentially revolutionizing both internal and independent audit procedures. And finally, AI has greatly improved optical character recognition, allowing documents such as contracts and reports to be read and analyzed by machine.

However, AI has raised ethical and security concerns. A meeting in September 2023 between noted U.S. executives such as Elon Musk (Tesla), Mark Zuckerberg (Meta), Bill Gates (Microsoft) and Sundar Pichai (Google) and U.S. Senators focused on the need to regulate AI. It was widely reported that all agreed on the need for regulations but there was no consensus on what form and to what extent regulatory oversight should be shaped.

On a social level, such issues as the impact AI may have on employee well-being, protection of creative and proprietary rights, and disruption to the social framework have been spotlighted. Last year's strike by the Screen Actors Guild brought some of these risks into the spotlight. One of the points of contention involved the ability of the film studios to use actor's voices and images into perpetuity without their consent or compensation.

The Writers Guild voiced concern that AI can write or rewrite their material or use their material to be trained to produce original scripts. Although not directly related to the accounting profession, these issues highlight the concerns that AI raises in any profession.

AI has also been shown to be an effective tool in the dissemination of false information. In addition, it can violate privacy and promote bias. According to Stephen Hawking, "The short-term impact of AI depends on who controls it; the long-term impact depends on whether it can be controlled at all."

In response to concerns regarding AI, President Joe Biden issued an executive order in October of last year as an initial salvo in regulating its development and application. The broad order seeks to establish guardrails to protest privacy, avoid equity issues, protect jobs and prevent unethical uses.

The field is evolving rapidly and business professionals are not exempt from both the opportunities and risks it presents.

Want to learn more about emerging trends in AI? TXCPA offers a number of CPE programs. Go to our website to learn more and register.

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CPA Pipeline Issues Front and Center as TXCPA's **Advocacy Efforts Continue**

The 2023 session of the Texas Legislature was a success for TXCPA and our efforts to address some CPA pipeline issues. The CPA pipeline has been at the forefront of the profession and a national focus for several years, and TXCPA stepped up to address some aspects of the issue on the legislative front. From allowing students to begin to take the CPA Exam after completing 120 semester hours – SB 159 – to helping to pass legislation to expand the Texas State Board of Public Accountancy scholarship program – HB 2217 – TXCPA's advocacy will have a beneficial effect on the CPA pipeline.

The end of the 2023 legislative session did not end our work on the CPA pipeline. During the summer and fall of

Continued on page 8

GOVERNMENT AFFAIRS UPDATE

2023, TXCPA was deeply involved in offering comments, suggestions and ideas on State Board rules relating to the pipeline. At the State Board's November 2023 meeting, permanent rules were adopted relating to SB 159 and taking the CPA Exam after completing 120 hours.

TXCPA worked closely with the State Board in proposing language to clarify the makeup of the 21 hours of upper-level accounting coursework needed to begin to take the Exam. In addition, TXCPA was instrumental in assuring that the accounting research course is required for licensure but not required to test at 120 hours.

These and some other changes that the State Board has made in the rules will enable students and educators to better understand the education path to testing and licensure. These rules changes will become effective in early 2024 commensurate with the new CPA Exam launching. TXCPA will continue its work to streamline the Board rules for our members, students, educators and the profession.

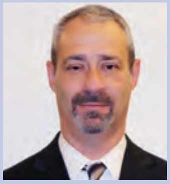
Another CPA pipeline issue TXCPA supported is the Applicant Reassessment Program. TXCPA worked closely with the State Board, NASBA, AICPA and other state societies in proposing a program that will permit over 18,000 candidates nationally, and over 1,900 in Texas, to reenter the CPA testing regime if they passed one or more sections between 2020 and 2024, but for hardship reasons fell out of the pipeline and could not continue testing.

Those applicants who are approved – by submitting an application detailing the hardship – will be given an additional 18 months to complete the CPA Exam. This is a second chance for those candidates who fell out of the pipeline for no fault of their own.

Nationally, TXCPA is continuing its close collaboration with AICPA and other state societies to lobby and advocate for federal legislation to address the CPA pipeline. Two issues are gaining momentum in Congress – expansion of 529 plans to allow for 529 funds to be used for credentialing, testing and licensing expenses in addition to traditional higher education expenses. The expanded use of 529s would enable CPA candidates, and other occupations and professions, to help defray the ever-increasing costs of testing and credentialing and maintain those individuals in their respective pipelines. There are close to 80 co-sponsors in the House and over 10 Senate co-sponsors.

Finally, efforts to add accounting to the federal STEM program – in the technology branch – have seen wide support in both chambers and it is hopeful that more legislative progress on both of these pipeline issues can be achieved.

Please reach out to TXCPA if you would like to help in our advocacy efforts and need additional information about these and other issues.



BY KENNETH BESSERMAN,
Director of Government Affairs and Special Counsel

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For TXCPA Member ARTURO MACHADO, the CPA License Unlocks Trust and Credibility

TXCPA member Arturo Machado, CPA-San Antonio, is a shareholder at Sol Schwartz & Associates, where he provides comprehensive tax consulting and compliance services to the firm's clients. With an impressive 20-year tenure in the accounting field, Arturo has honed his expertise, particularly in the area of international tax. During his career, he has held significant roles, including a position as a tax manager at one of the most prominent global accounting firms.

Arturo's contributions extend beyond his professional roles. He has actively participated in various tax forums focused on inbound and outbound tax issues related to domestic and international business operations. His knowledge and insights have also been shared with a wider audience through his published writings, including notable contributions to the Tax Adviser, Texas Realtor magazine and other respected outlets.

Arturo's commitment to professional development and community engagement is evident through his service on the TXCPA Leadership Council, and active involvement in leadership roles and chapter activities within TXCPA San Antonio, which ascended to him serving in the capacity of chapter president. In recognition of his exceptional achievements and leadership qualities, he was honored as the TXCPA Young CPA of the Year in 2017. Today's CPA recently caught up with Arturo to learn more about his career and service to the accounting profession.

You are a Shareholder at Sol Schwartz & Associates in San Antonio. Tell us about your background and career.

I was born in El Paso but lived in Mexico the first years of my life, including places in the states of Sonora and Chihuahua. Throughout my elementary years, we lived in the border city of Cd. Juarez, and commuted back and forth from Juarez to El Paso, as my parents were adamant that we not only attend school in the U.S., but that it was a private school so as to provide a foundational framework from a personal and spiritual perspective.

After high school, I attended The University of Texas at El Paso, where I received both my undergrad in accounting and my Masters in Business Administration. While attending college, I held various positions, with my last one before graduating as a staff accountant of a multinational corporation, where I first worked within my field of study. Shortly after graduation, I worked with a local CPA firm and that was where I knew that I had found my calling working in the public arena.

After a couple of years with this firm, I was afforded the opportunity to join KPMG in the El Paso office. Within KPMG, I transferred from the El Paso to the San Antonio office back in 2005, where I spent the next several years. It was there that I was exposed to multinational clients and where I decided to pursue a specialization in international tax. After leaving KPMG, I spent a short period of time with a wealth management firm and ultimately landed a position with Sol Schwartz & Associates, where I've been for the past 10 years.

What are your responsibilities at your firm?

My primary responsibility is to lead our fast-growing international tax practice, which includes the practice development activities as well as training and mentoring the staff. I was fortunate enough that when I joined Sol Schwartz, there was already a vibrant international tax practice, which allowed me the platform to continue growing and developing it. It's amazing to realize that we now serve clients not only from Mexico, but also throughout Latin America, some South American countries, Asia and Europe!

In addition to leading the international practice, I serve as the partner in charge of our marketing department, where I work closely with our marketing director.

At what point in your life did you know you wanted to be a CPA?
In high school, I always enjoyed my math and business classes and just knew I had a knack for numbers. When I started college and had to choose a major, I never really had a doubt that I wanted to study accounting. However, it wasn't until my first job in public accounting that I saw the true potential of having the CPA license. I recall my first client meetings, being in there with a manager or partner, and just how the attention of the clients was clearly set on them, how everything they said was taken with a higher level of credibility and trust. I knew then that simply having an accounting degree would not be enough if I aspired to garner that same level of trust with my clients.

Left to right:
Arturo Machado, Karla Machado, Allison Machado and Karen Machado

What advice would you give students who would like to pursue the accounting profession as a career and become CPAs?
I would tell them it's a difficult road that requires much effort and sacrifice, that it will require many long nights and instances that will truly test your willpower and put you at the precipice of deciding whether to quit or push forward. However, if you have the gumption to persevere, you will feel an incredible sense of accomplishment.

Theodore Roosevelt once said, "Nothing worth having comes easy," which couldn't be more true. As such, if you are deciding to pursue an accounting degree and further seek the CPA license, do it, but only if you are fully committed from the heart and ready to face the challenges that will come your way, and know that in the end, it will all be worth it.

> **"Volunteering in the committees allowed me to get to know fellow CPAs from other firms and get to meet them at a personal level. I realized early on how valuable this could be."**

You've actively served in numerous leadership roles in your chapter and for TXCPA. Why is volunteering and/or committee service so important to you?
There are many reasons why volunteering has been and continues to be an important part of my career. It allows me an opportunity to give back to an organization that has given me much.

When I first became a CPA, I was working at a big four firm and as such wasn't looking to TXCPA for CPE, which I know can be incredibly valuable to other members. Rather, I was looking to connect with other fellow CPAs in the community. I was still relatively new to San Antonio and outside of my organization, I didn't really know many of my peers. Volunteering in the committees allowed me to get to know fellow CPAs from other firms and get to meet them at a personal level. I realized early on how valuable this could be.

As I continued my efforts and began participating in student events, I understood that we have not only a responsibility but an opportunity to inspire the next generation to pursue an accounting degree and the CPA license.

Tell us about your family. What do you like to do on the weekends?
My wife Karla and I have been together for 23 years, and we have two daughters, Karen and Allison, who are 19 and 11, respectively. My wife has an education degree and works at the same middle school that Allison attends. Karen is currently attending Texas Tech University. I'm still working to convince her to study accounting but haven't quite gotten there yet 🙂.

As for my siblings, I'm the eldest of five. One of my brothers is a U.S. Marshall, another is an occupational therapist and my sisters both work in tax. I am fortunate enough to still have my parents with us and they both live here in San Antonio.

On weekends, we do a variety of things, from spending time with family, grilling, drinking cold beer and watching sports. I enjoy playing golf but have to admit it gets difficult finding the time to get out for a round. No one really prepared me for this being an "adult" thing, lol.

Also, I very much enjoy traveling with my family and making memories. Those are the precious moments where we hit the pause button from our daily routine and just take it all in. I truly hope that even as our girls get older, they'll want to continue traveling with their parents. I try to take my parents with us on as many trips as possible, as those moments will never happen again … and regret is a hell of a thing.

Month of Service

TXCPA Fort Worth members participated in SANTACCOUNTANTS for the 34th year! This year, generous TXCPA members collected new toys and warm clothes for 745 kids in Tarrant and Hood counties.

TXCPA member Karen Horne, CPA-Fort Worth, handcrafted 15 beautiful quilts for children at the Center for Transforming Lives during TXCPA's Month of Service. The quilts were wrapped and distributed during the SANTACCOUNTANTS program.

TXCPA Wichita Falls members volunteered at a local food bank. The chapter collected 453 pounds of food.

On November 7, TXCPA Houston members and guests volunteered at the Houston Food Bank.

TXCPA's Strategic Partner, Goodman Financial, embraced the season of giving by providing each of their 23 employees with $1,000 to donate to their favorite charity.

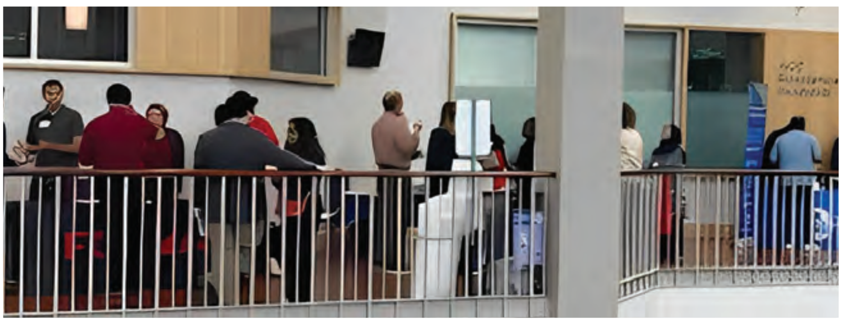
TXCPA Members Gave Back in November With Impactful Participation in Service Month and Career Awareness

TXCPA's Accounting Opportunities Month, held in conjunction this year with our annual Month of Service, showcased the remarkable dedication of members in making a meaningful impact in your communities. Through volunteer efforts like visiting classrooms and supporting local causes, TXCPA members inspired future CPAs and contributed to charitable organizations across Texas.

The diverse range of activities, from educational and career awareness outreach to charitable initiatives, displayed the collective strength and generosity of TXCPA members. The activities not only benefited local communities but also highlighted the broader role CPAs play beyond their professional roles. The success of this initiative underscores the importance of members giving back and inspiring the next generation.

We thank all the TXCPA members who participated for your commitment and impact during Month of Service and Accounting Opportunities Month, showcasing your generosity and desire to make a positive change in Texas. Here are a few of the ways members and chapters participated in November.

In What's Happening Around Texas, we give you highlights of events and activities happening around the state in the TXCPA chapters.



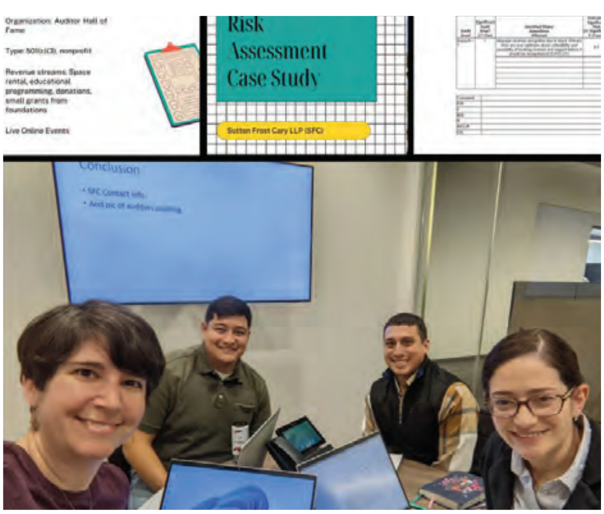
Accounting Opportunities Month

On November 7, Christine Wells , CPA-Central Texas, gave an accounting careers presentation to University of Mary Hardin Baylor students. There were about 25 students in attendance.

TXCPA Austin and Austin Community College partnered to offer a Career Fair to student members on November 11 at the ACC Highland Campus.

On November 14, Rachel Glasser, CPA-Fort Worth, volunteered her time to help students at The University of Texas at Arlington complete a risk assessment case study.

On November 16, Jeffrey McCormick, CPA-San Angelo, spoke to students at Angelo State University's Beta Alpha Psi monthly meeting. During his presentation, Jeffrey discussed the many different career opportunities available to those with accounting degrees and the benefits of obtaining a CPA license.



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Join us in Corpus Christi for the TXCPA Midyear Meeting, January 25-26, 2024

Break in your new 2024 calendar and add the TXCPA Midyear Meeting in Corpus Christi to January 25-26. The agenda will include valuable profession and TXCPA updates, networking opportunities to meet and connect with other leaders from across the state, and some fun in the sparkling city by the sea! Meeting registration and other details can be found in your member communications and in the Leadership Meetings section of www.tx.cpa.

Now Hiring? Turn to the TXCPA Career Center

The TXCPA Career Center is the perfect place to post your open positions for new and experienced accounting staff. Internship postings are always free and members receive discounts on all other job postings.

Make your postings stand out with highlights about your organizational culture, any unique benefits that set you apart, and details about growth and involvement opportunities candidates will experience if they choose to join your team.

We look forward to helping you find your next superstar! Visit careers.tx.cpa to get started.

MAXIMIZE YOUR MEMBERSHIP: Visit TXCPA Exchange For Quick Guidance this Tax Season

Your membership includes access to our members-only forum TXCPA Exchange. New posts are added daily with helpful advice and informal guidance from our community of 28,000 members.

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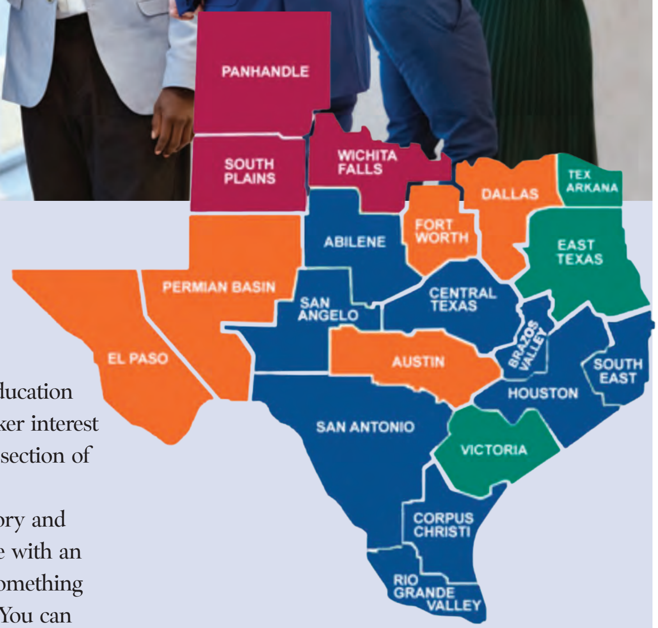
Visit exchange.tx.cpa and search or start a new discussion today!

Is Your Organization Taking Advantage of Professional Group Membership Benefits?

Organizations with more than one TXCPA member are eligible for special group membership benefits. Participation in TXCPA's Professional Group Membership program ensures that your membership dues investment returns the highest value.

In addition to giving TXCPA members in your organization access to free ethics and other free online CPE programs, you'll benefit from additional savings on the TXCPA Passport on demand CPE subscription package, a dedicated TXCPA contact for all of your registration and renewal needs, a free job posting in the TXCPA Career Center, one free membership for a non-CPA member on your team, and MORE.

Current participants can review their rosters online and get started on 2024-2025 renewals now! New participants can contact membership@tx.cpa to get added to the program and open up additional benefits today!



Resolve to Get Involved in 2024!

One of the best ways to maximize your membership is through involvement in TXCPA and your local chapter. If the new year brings new goals for your career and personal development, we have some fantastic opportunities to help you grow in 2024!

You can hone your leadership skills, give back to your local community, inspire a future CPA, shape the future of your profession, advocate for CPAs, and lend your talents to TXCPA member programs and offerings. We're here to help you connect to the opportunity that best fits your schedule and needs.

If you're interested in TXCPA committee service, you can find a list of our current committees and submit your interest in the Get Involved section of tx.cpa.

Are you interested in presenting a session at one of our live or webcast continuing professional education programs? Submit a speaker interest form in the Be a Speaker section of tx.cpa.

Maybe sharing your story and the opportunities available with an accounting education is something that sparks your interest. You can complete a speaker interest form in the **Get Involved** section of tx.cpa to be notified about any opportunities to speak with Texas students.

We encourage you to explore volunteer opportunities offered close to home by reviewing volunteer options offered by your local chapter. Chapter websites are listed on the **Find Your Chapter** page of tx.cpa.

However you choose to be engaged, we're grateful for your time and service in 2024 and beyond!

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THE FUNDAMENTALS OF VALUE PRICING

BY ED KLESS

Pricing for profit is critical to the health and success of your business, yet many firm owners just don't realize the impact that pricing has. When you set your prices correctly, you gain a significant edge over your competitors. By contrast, when you set your prices incorrectly, it can be very hard to recover. So, how do you set your prices correctly?

SETTING PRICES CORRECTLY IS KEY TO YOUR FIRM'S SUCCESS

Many firm leaders don't realize that pricing is the *top driver of profitability* for almost every kind of business, including accounting firms. Study after study by many different consultancies has confirmed this fact.

For example, research by McKinsey and A. T. Kearney revealed the following:

- 1% increase in price can yield an increase in profits of 7% to 11%;
- By contrast, a 1% reduction in fixed costs improves profitability by only 1.5% to 2.7%;
- And likewise, a 1% improvement in revenue raises profitability by only 2.5% to 3.7%.

BIGGEST MISTAKES TO AVOID IN SETTING PRICES

The single biggest mistake businesses make is setting prices too low and then having to raise their prices after they've been in business a while.

A second significant mistake is offering one and only one price. Firms that are effective at pricing, without exception, give their customers choices in their prices. Take the Starbucks model, for example: you have multiple size options – tall, grande and venti. FedEx and UPS also offer a variety of options – standard overnight, priority overnight, two-day delivery and so on.

Firms should give their clients price options because there is a range of acceptable prices a client is willing to pay based on the value they perceive in what they're purchasing. On the other hand, if your business offers only one choice, it's difficult for your client to establish a context around the price. Multiple price options based on what's being sold help the client establish that context and choose the product or level of service they desire.

Sadly, many firms attempt to correct for this by quoting a low-to-high range. This creates friction in the relationship from the beginning since the prospect/client will only remember the low and the professional will only remember the high. In addition, it is confusing. Imagine going into a store and seeing the price of milk as between $3-$6.

> Firms should give their clients price options because **there is a range of acceptable prices a client is willing to pay** based on the value they perceive in what they're purchasing.

EXAMPLE PROFESSIONAL FIRM OFFERING

Let's begin by creating a grid with the three options down the left and the first feature of the access level (response time) across the top. We will use the American Express "Green, Gold, Platinum" metaphor and response times of six, three and one hour(s), respectively. Please note, your mileage may vary (as they say in the car commercials). It could be that your clients expect quicker response times and that your offering would be for one-hour, 30-minute and 15-minute responses. This is just an example to assist your thinking.

Please see Table 1. Notice the first level presented will be the most expensive. We'll discuss more on why this is later.

To clarify, what you are offering is your guarantee that you will respond to a client with the selected level's response time. You are not saying you will be able to answer their question or solve their problem within this time, just that you will be able to respond to them and begin the process of diagnosing the situation for them.

Now, it may be that you can answer the question or solve the problem, but it is important that you explain that this will not always be the case. Many organizations that have implemented access-level agreements refer to these as diagnostics and just like with a doctor, a diagnosis is not the same as a cure.

The next step is to create more offerings to go across the top. Some of the more common offerings include frequency of face-to-face meetings, tax and estate planning, and agreeing to meet with other professionals such as financial planners or lawyers to discuss a matter relevant to the client, representation before the IRS and so on.

Now let's add some of these across the top and drop in some ideas about what is or is not included at each level. Please see Table 2.

As a reminder, this is an example; your access-level agreement will likely contain a dozen or more features across the top. The number of items you can bundle in is limited only to your creativity.

A great place to start is to talk to your clients about their needs and wants. Take a group of clients to breakfast or lunch to brainstorm ideas. Be sure to include different types of clients both from a demographic and psychographic standpoint. Include some of your best clients, as well as some of your clients who don't think you are so great.

Including the clients who do not think you are so great has a two-fold purpose. First, when they talk to some of your better clients, they may get a better understanding of what you are able to do for them, as well. I have witnessed a D customer become a B customer by just talking to an A customer.

Second, it allows you to observe what not to build into your agreement. You do not want to create an agreement that will attract more D-type clients.

KEY DIFFERENCE BETWEEN COST-BASED PRICING AND VALUE-BASED PRICING

This topic is often misunderstood. Sadly, most people think price should be based primarily on cost. In fact, often business

Table 1. Access Levels and Response Times	
Access Level	Response Time (In Business Hours)
Platinum	1
Gold	3
Green	6

Table 2. Access Levels, Response Times and Offerings				
Access Level	Response Time	Face-to-Face Meetings	IRS Representation	Main Professional Coordinator
Platinum	1 Hour	3	Power of Attorney and Response	Yes
Gold	3 Hours	2	Power of Attorney, Call to You	Yes
Green	6 Hours	1	Advice Only	No
No Plan	2 Days	0	None	No

owners think only about cost when it comes to setting price. In the vast majority of cases, however, cost should not be the number-one driver of price!

What should be the primary driver? It should be the perceived value the client places on the service or product. That's not to say that value is the sole determinant of cost – pressures from your competitors, as well as other factors also get considered when setting price. However, in my experience, most people think cost is the top driver in setting price, when in fact value is the top driver.

This concept is known as value-based or value-led pricing. Central to this concept is the idea that the value to the client of your service or product enables you to set a price and then the price you can get justifies your costs.

HOW TO SET PRICES BASED ON VALUE-LED PRICING MODEL

The first concept that firms adopting value-led pricing need to absorb and act on is that there is no such thing as the objective value of a product, service or knowledge being sold. Value is entirely subjective to the client and, to some extent, the circumstances and situation at hand.

That means that in order to properly set the price, firms need to understand what's the subjective value to the client. Let's take a simple example. A bottle of water an individual buys at a sports stadium (especially on a really hot day) is worth a lot more to that consumer than when they pour themselves a glass of water from their kitchen faucet.

Likewise, the same water when flooding your basement has negative value. From a cost standpoint, getting the water to those locations is the same. Again, prices are not based on costs; they justify them.

A second key change in mindset is to understand that your firm should price your clients – not your services or products. For example, professional services firms like accounting firms might price individual clients based on the value to the client of the firm's services. A multinational cell phone carrier, meanwhile, will price a large segment of clients they want to target.

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HOW MUCH TIME SHOULD YOU DEVOTE TO TRACKING YOUR COMPETITORS' PRICING?

Naturally, you need to be aware of what your competitors are charging for their services and products, and you want to understand the contexts they're establishing that help their clients determine value. But very few small businesses should devote much time and resources to monitoring competitors' prices.

It's more important to figure out how to differentiate what you do compared to your competitors and to make what you sell truly different.

PORTABILITY

Take a Closer Look with the 2025 Sunset on the Horizon

Representing a Tax Client Who Has Lost a Spouse

BY NIKKI L. LAING, CPA, JD

KEY TERMS:

- » **Portability Election**
- » **Federal Estate Tax Exemption**
- » **Taxable Estate and Taxable Lifetime Gifts**

When a client's spouse dies, the client is likely overwhelmed. In addition to grieving the loss of their life partner, they face a seemingly endless list of tasks that must be completed.

So, it comes as a relief when the client hears from their CPA, probate attorney or other advisor that no federal estate tax return is required by the tax laws to be filed for the deceased spouse. Strike it off the list and move on! However, the client's tax practitioner must be alert to the fact that, just because a federal estate tax return is not compulsory under the tax laws, it does not necessarily mean that one should not be filed anyway.

In some cases where filing is not mandatory, it is appropriate to file a federal estate tax return to transfer the deceased spouse's unused federal estate tax exclusion to the surviving spouse.[1]

When filing an estate tax return is not mandatory under the tax laws, the filing decision depends on a simple formula. First, find out the date the surviving spouse plans to die. Second, compute what the combined value of the surviving spouse's estate and taxable lifetime gifts will be on that date. Third, determine what the federal estate tax exemption will be on that date.

If the surviving spouse intends to die on a date when the federal estate tax exemption exceeds the combined value of the surviving spouse's estate and taxable lifetime gifts, there is no need to file an estate tax return for the deceased spouse. If the surviving spouse plans to die on a date when the federal estate tax exemption is below the combined value of the surviving spouse's estate and taxable lifetime gifts, an estate tax return should be filed for the deceased spouse so that the deceased spouse's unused federal estate tax exclusion can be transferred to the surviving spouse.[2]

The implausible scenario in the previous paragraph was prompted by the author's

When a person dies, the person's federal estate tax basic exclusion amount (i.e., the exclusion in effect for the year of death) is applied against the combined value of the person's taxable estate and taxable lifetime gifts.

conversations with surviving spouses and their advisors in which they have lamented that the portability decision would be easier if at least one of the three variables in the formula could be predicted. However, the fundamental formula in the scenario is valid, and the author's goal is to encourage tax practitioners to consider this formula when counseling a surviving spouse and examine whether an estate tax return should be filed for the deceased spouse, even when not required by law.

FILING NOT REQUIRED IF UNDER EXCLUSION

Generally, filing a federal estate tax return (Form 706) for a deceased person ("decedent") is not required by law if the combined value of the decedent's gross estate and taxable lifetime gifts is below the decedent's basic exclusion amount.[3] The basic exclusion amount is $12.06 million for decedents dying in 2022,[4] $12.92 million for decedents dying in 2023[5] and $13.61 million for decedents dying in 2024.[6] A comprehensive discussion of all of the items that constitute the gross estate and taxable lifetime gifts is outside the scope of this article.

FILING REQUIRED TO TRANSFER DECEASED SPOUSE'S UNUSED EXCLUSION TO SURVIVING SPOUSE

When a person dies, the person's federal estate tax basic exclusion amount (i.e., the exclusion in effect for the year of death) is applied against the combined value of the person's taxable estate and taxable lifetime gifts.[7] If the combined value of the taxable estate and lifetime gifts is below the person's exclusion, not all of the person's exclusion will be used and there will be some exclusion remaining. If the person was not married at the time of death, any remaining exclusion is lost and cannot be used by anyone else.

However, if the person was married at the time of death, the remaining exclusion (commonly referred to as the deceased spousal unused exclusion amount, or "DSUE" amount) can be transferred to the person's surviving spouse.[8] This concept of transferring the deceased spouse's unused exclusion to the surviving spouse is called "portability."[9]

The opportunity to transfer the DSUE amount to the surviving spouse is available only if appropriate action is taken in a timely manner. Electing portability on a timely-filed Form 706 is currently the only way

Portability adds the decedent's unused federal estate tax exclusion amount to the decedent's surviving spouse's own basic exclusion amount that is already available to the surviving spouse for both federal gift and estate tax purposes.

for the decedent's unused exclusion to be transferred to the decedent's surviving spouse.[10] Practitioners should compare the estimated combined value of the surviving spouse's taxable estate and taxable lifetime gifts to the range of federal estate exemption levels that may apply to the surviving spouse in the future to determine whether it is advisable to seize this opportunity.[11]

VALUABLE OPPORTUNITY TO REDUCE OR ELIMINATE GIFT AND ESTATE TAX

Portability adds the decedent's unused federal estate tax exclusion amount to the decedent's surviving spouse's own basic exclusion amount that is already available to the surviving spouse for both federal gift and estate tax purposes.[12]

When the portability election has been made on a timely-filed Form 706, the surviving spouse can then use the DSUE amount against the surviving spouse's lifetime gifts and when the surviving spouse dies, the personal representative of the surviving spouse's estate can apply the DSUE amount against the surviving spouse's taxable estate – all in addition to the surviving spouse's own basic exclusion amount, which remains fully available for use against the surviving spouse's lifetime gifts and estate at death.[13]

CURRENT HIGH EXEMPTION SUNSETS ON DECEMBER 31, 2025

Keep in mind that, while the federal gift and estate tax exclusion available to a person today is 10 million dollars, adjusted for inflation ($13.61 million in 2024), the law that established the current historically high exclusion levels expires ("sunsets") December 31, 2025.

On January 1, 2026, the per-person exclusion amount drops to five million dollars, adjusted for inflation.[14] Therefore, the tax practitioner should keep this "sunsetting" of the current high exemption levels in mind when helping the client to decide whether to file an estate tax return for the client's deceased spouse.

SURVIVING SPOUSE HAS SIGNIFICANT ASSETS OR HAS MADE SIGNIFICANT LIFETIME GIFTS

Arguably, filing an estate tax return to elect portability is essential when the combined value of the surviving spouse's assets (including assets that the surviving spouse receives as a result of the death of the deceased spouse) and taxable lifetime gifts exceeds the current exemption ($13.61 million in 2024). If an estate tax return is not filed now for the deceased spouse, the chances are high that estate tax will be due at the death of the surviving spouse (to the tune of 40% of the amount that the combined value of the surviving spouse's taxable estate and taxable lifetime gifts exceeds the exemption in effect on the date of the surviving spouse's death).

Filing an estate tax return to elect portability should be seriously considered when the combined value of the surviving spouse's assets (remembering to include assets that the surviving spouse receives as a result of the death of the deceased spouse) and taxable lifetime gifts is near the current exemption ($13.61 million in 2024), because the DSUE amount may be needed to offset any growth in the value of the surviving spouse's assets that outpaces any future increases in the estate tax exemption.

Or, as discussed in the next section, the DSUE amount might be needed to supplement the surviving spouse's own basic exclusion amount if the surviving spouse dies after December 31, 2025, and Congress does nothing to extend the current high exemption levels.

If an estate tax return is not filed now for the deceased spouse, estate tax could be due at the death of the surviving spouse (40% of the excess of the surviving spouse's taxable estate and lifetime gifts over the exemption in effect on the date of the surviving spouse's death).

SURVIVING SPOUSE HAS MODERATE ASSETS – EXEMPTION PLUMMETS IN THE FUTURE

Given that under current law the federal gift and estate tax exemption is scheduled to drop to $5 million (indexed for inflation) in 2026,[15] filing an estate tax return to elect portability may be appropriate even when the combined value of the surviving spouse's assets (including assets that the surviving spouse receives as a result of the death of the deceased spouse) and taxable lifetime gifts is well under the current exemption amount.

Consider the following hypothetical. A married decedent dies in 2023, when the exemption is $12.92 million. The value of the decedent's estate is $5 million and the value of the surviving spouse's estate is $3 million. The decedent's entire estate passes to the surviving spouse.

An estate tax return is not mandatory under federal tax law. After inheriting $5 million from the deceased spouse, the value of the surviving spouse's estate is now $8 million. The surviving spouse dies in 2026 when the exemption is $7 million.[16] If no estate tax return was filed for the spouse who died in 2023, there may be estate tax of $400,000 owed at the death of the surviving spouse in 2026 ($8 million estate – surviving spouse's $7 million basic exclusion amount = $1 million taxable estate x 40% = $400,000).

In contrast, if an estate tax return had been filed for the spouse who died in 2023, there is no estate tax owed when the surviving spouse dies in 2026 because the DSUE amount of $12.92 million transferred from the spouse who died in 2023 to the surviving spouse, plus the surviving spouse's own $7 million basic exclusion amount, will be applied to the surviving spouse's $8 million estate. So, in this hypothetical, filing an estate tax return for the spouse who died in 2023, even though not required by law, would save $400,000 in estate tax.

Imagine if the reason the estate tax return was not filed in this hypothetical was because the tax practitioner had not made the client aware of the concept of portability! Please see Graph 1, Fluctuations of the Estate Tax Exemption.

REASONS CLIENTS MAY DECLINE TO FILE FOR PORTABILITY

There could be one or more downsides to filing an estate tax return for portability. The cost of having an estate tax return prepared and the uncertainty of future circumstances (e.g., multiple unknown variables such as the value of assets remaining at the surviving spouse's death and what the exemption will be at the surviving spouse's death) may be the most common factors that discourage filing. Similarly, the time commitment, effort and cost involved in gathering information and documents and engaging appraisers and business valuation experts may tip the scales against filing.

One point to consider when making the filing decision is that, when the portability election is made, the IRS is allowed to examine the return after the relevant limitation periods have expired for the restricted purpose of making determinations with respect to the DSUE amount.[17] This may or may not be a deterrent to filing.

Another consideration is that a surviving spouse is limited to using the DSUE amount of the last deceased spouse,[18] so in the narrow set of facts where the surviving spouse files an estate tax return to elect portability of their deceased spouse's unused exclusion, marries a new spouse and then is predeceased by that new spouse, it would be possible for the surviving spouse to lose all or a portion of the benefit of portability of the first deceased spouse's unused exclusion.[19] This remote possibility of losing the benefit of portability may be a dissuading factor in the filing decision.

SIMPLIFIED RULES FOR PORTABILITY-ONLY RETURNS

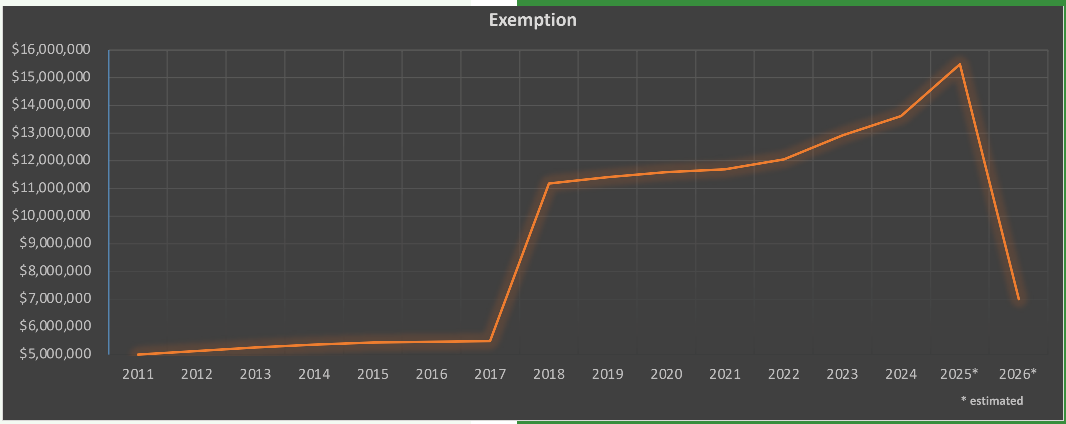
One facet that may swing the pendulum toward filing a portability return is the relaxed rules that are available for returns that are filed solely to elect portability.

Relaxed Valuation Method. When an estate tax return is filed for the purpose of electing portability, the value of certain property that qualifies for the marital or charitable deduction can be estimated on the return.[20] In such a case, no formal appraisals or formal valuation reports are needed to support the estimated values for those assets.

Extended Filing Deadline. Generally, an estate tax return is due within nine months after the date of the decedent's death[21] or within 15 months with a timely-filed extension.[22] A special five-year extension is available for filing an estate tax return to elect portability for an estate that is not otherwise required to file an estate tax return.[23] This relief enacted by the IRS in July of 2022 came as welcome news to tax practitioners, surviving spouses and other interested parties (likely including a number of professional liability insurance carriers!).

If no estate tax return is required to be filed, this special extension may be obtained by filing Form 706 on or before the fifth anniversary of the decedent's death and stating at the top of the return that it is "Filed Pursuant to Rev. Proc.

Continued on page 26



DOCUMENTING THE DISCUSSION WITH THE CLIENT

When factors indicate that electing portability may be beneficial, the tax practitioner should discuss the general advantages and disadvantages of filing with the client (or refer the client to a practitioner who is qualified to provide such advice to the client).

It is recommended for the tax practitioner to be in communication with the probate attorney representing the executor of the decedent's estate. Often the surviving spouse serves as the executor of the deceased spouse's estate, which can simplify the communication and decision-making process.

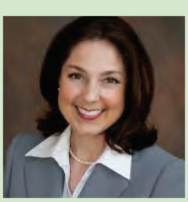
The goal is to explain the general concepts, advantages and disadvantages of filing a portability return to the client and recommend collaboration with the probate attorney, the decedent's and surviving spouse's financial advisor(s) and other professionals to assist with gathering the specific details required to make an informed decision on filing.

The tax practitioner should document the portability discussion and the client's decision on whether to file. The practitioner may wish to provide a letter to the client summarizing their discussion on the advantages, disadvantages, deadline, etc. relating to filing a portability return and request for the client to return a signed copy of the letter with the client's filing decision noted on the letter.

TAKING A CLOSER LOOK AT UTILIZING PORTABILITY

Following the death of a spouse, the surviving spouse is likely not immediately concerned about minimizing future federal transfer tax liability, especially in light of today's relativity high exemption. However, absent legislative action, significant changes are in store for transfer tax laws when the current law sunsets on December 31, 2025.

The surviving spouse may not realize that there is action that can be taken now to increase the reserve of exclusion that can be used to minimize or eliminate gift and estate tax liability many years down the road. When appropriate, the tax practitioner should encourage the client to take a closer look at utilizing portability of the client's deceased spouse's unused exclusion.



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FOOTNOTES

[1] This article has been adapted from the author's paper originally written for probate lawyers titled "Don't Miss the Boat! Using Portability as a Lifeline in the Unpredictable Seas of Gift and Estate Tax," published in the Real Estate, Probate, and Trust Law Reporter, Volume 61, Number 2 (Spring 2023).
[2] While this formula is a tongue-in-cheek demonstration of the uncertainty involved in predicting whether the deceased spouse's unused federal estate tax exclusion will be needed by the surviving spouse, it contains a legitimate basic calculation for the surviving spouse and their advisors to consider.
[3] I.R.C. § 6018.
[4] Rev. Proc. 2021-45.
[5] Rev. Proc. 2022-38.
[6] Rev. Proc. 2023-34.
[7] I.R.C. § 2010.
[8] Treas. Reg. § 20.2010-2.
[9] Id.
[10] Treas. Reg. § 20.2010-2.
[11] Some estate planning documents explicitly direct the decedent's personal representative to elect portability, so the deceased spouse's Will (and revocable trust, if appliable) must be reviewed to see if there are instructions regarding electing portability of the decedent's unused exclusion amount.
[12] I.R.C. § 2010(c)(2).
[13] Treas. Reg. § 20.2010-2.
[14] I.R.C. § 2010(c)(3)(C).
[15] Id.
[16] The figure of $7 million has been used by commentators to roughly represent the 2026 exemption of $5 million, indexed for inflation, and it is used here purely for demonstration purposes.
[17] I.R.C. § 2010(c)(5)(b).
[18] I.R.C. § 2010(c)(4)(B)(i).
[19] The amount of DSUE that would be lost as a result of the death of the surviving spouse's new spouse would depend on whether the surviving spouse had applied some or all of the DSUE to the surviving spouse's lifetime gifts prior to the death of the new spouse. If so, the portion of the DSUE applied to lifetime gifts would not be lost.
[20] Treas. Reg. § 20.2010-2.
[21] I.R.C. § 6075.
[22] Treas. Reg. § 20.6081-1.
[23] Rev. Proc. 2022-32.

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Handling an Estate with S Corporation Stock

BY JOVANA POPOVICH

KEY TERMS:

S Corporation Election

Qualified Subchapter S Trusts

Electing Small Business Trust (ESBT)

Grantor Trusts and Qualified Revocable Trusts

No matter your level of experience in estate administration matters, it is prudent to revisit the Code and Regulations whenever working on an estate where the decedent owned S corporation stock at death so as not to inadvertently terminate the corporation's S status.

This article aims to provide a high-level overview and reference tool covering the practical, procedural and timing matters applicable to estates and testamentary trusts that typically arise during an estate administration. This article is not intended to be a substitute for a thorough analysis of the pertinent Code and Regulations provisions, but rather a basic reference tool for practitioners to consult as a high-level guide.

PERMISSIBLE SHAREHOLDERS OF S CORPORATION STOCK

Code Section 1361 provides the requirements that a corporation must meet to make an S corporation election. Among other restrictions, the corporation can have no more than 100 shareholders and only certain persons own stock in the corporation. These eligible shareholders include, but are not limited to, U.S. citizens and resident aliens, estates of individuals who were eligible S corporation shareholders at death, and certain trusts. (Code Sections 1361(b)(1) and 1361(c)(2)).

Importantly, a single ineligible shareholder can cause an existing S corporation to lose its S status and automatically convert to a C corporation. (Code Section 1362(d)(2)). As noted above, this article focuses on the circumstances and procedural requirements under which estates and testamentary trusts can qualify as S corporation shareholders so as to ensure the underlying corporation maintains its S status.

ESTATES

The estate of a U.S. citizen or resident alien qualifies as an eligible S corporation shareholder for the duration of the administration of the estate. (Section 1361(b)(1)(B)). Under long-standing case law, an estate is considered "under administration" during the reasonable period necessary for the executor to perform all of the duties with respect to the distribution and administration of the estate. See, e.g., *Old Virginia Brick Co., Inc. v. Comm'r.,* 66-USTC 9708.

Where the estate administration is unreasonably prolonged, the estate is deemed terminated and the S corporation stock deemed distributed to the beneficiaries. (Id.) Note, however, the IRS will not consider the administration of an estate unreasonably prolonged if the purpose is to pay estate tax on an installment basis under Code Section 6166. (Rev. Rul. 76-23, 1976-1 C.B. 264).

S corporation stock held in a minor's or incompetent person's estate is deemed owned by such person directly and is not considered to be held by an estate for purposes of Section 1361. (Rev. Rul. 66-266, 1966-2, C.B. 356). Additionally, with respect to the 100-shareholder limit and the applicable stock attribution rules, any estate's S corporation stock is treated as owned directly by the decedent. (Code Section 1361(c)(1)(A).

TESTAMENTARY TRUSTS

A trust that receives stock of an S corporation pursuant to the terms of a will is automatically considered a qualified S corporation shareholder for a two-year period beginning on the date the stock is transferred to the trust. (Code Section 1362(c)(2)(A)(iii). The Code defines trusts in this category only by the nature of the transfer of S corporation stock. Therefore, it is not relevant whether the trust receiving S corporation stock is created by the same testamentary instrument or if it is a pre-existing trust. See *Treas. Reg.* 1.1361-1(k)(1), Example 3(i). During the two-year period, the S corporation stock is deemed owned by the estate of the testator whose will transfers the relevant stock.

In the absence of another means of qualification, such as the trust being a grantor trust as to the owner (discussed below), a trustee of a testamentary trust may find itself with a two-year limit on retention of the S corporation stock. Importantly, however, a testamentary trust meeting certain requirements can be an eligible S corporation stock shareholder indefinitely if it elects to be treated as an Electing Small Business Trust (ESBT) or as a Qualified Subchapter S Trust (QSST). The rules for trusts to qualify as ESBTs or QSSTs are discussed in detail below. (Treas. Reg. 1.1361-1(h)(3)(i)(B)).

A testamentary trust that intends to become a QSST or ESBT must file the applicable election within two months and 16 days after the end of the two-year automatic qualification period for testamentary trusts discussed above.

In most cases and for administrative simplicity, it is best practice to retain the S corporation stock in the estate until the ultimate distribution of the estate assets and then make the appropriate election for the testamentary trust to be effective as of the date of the stock transfer from the estate.

From a planning standpoint, it is therefore important to draft the testamentary trust provisions to allow for ESBT or QSST qualification. During the administration of the estate, the executor should determine (a) which type of election is permitted by the terms of the will and is in the best interests of the beneficiaries, and (b) ensure that the requisite election is ultimately made, as failure to timely make the appropriate election can result in the loss of S status for the corporation.

In most cases and for administrative simplicity, it is best practice to retain the S corporation stock in the estate until the ultimate distribution of the estate assets and then make the appropriate election for the testamentary trust to be effective as of the date of the stock transfer from the estate.

Below is a discussion of the requirements for electing QSST and ESBT status for trusts, as well as the procedures and deadlines for making the elections.

QUALIFIED SUBCHAPTER S TRUSTS (QSST)

Created by the *Economic Recovery Act of 1981*, the QSST is the first of two elective treatments that allow a trust to remain an eligible shareholder of an S corporation for an indefinite duration. Under Code Section 1361(d)(3), a trust must meet the following criteria to qualify as a QSST:

- All trust income must be distributed to a single income beneficiary who is a U.S. citizen or resident alien until the earlier of the death of the beneficiary or the termination of the trust;
- Any principal distributed during the current income beneficiary's lifetime must be distributed only to that beneficiary; and
- The trust agreement must provide that if the trust is terminated during the beneficiary's lifetime, all trust assets are to be distributed to the current income beneficiary.

The requirement for income to be distributed to a single income beneficiary is often cited as the largest disadvantage of a QSST. The income distribution requirement effectively causes the income to accumulate in the taxable estate of the current income beneficiary, deprives the trust income of protection from the income beneficiary's creditors and former spouses, and allows other beneficiaries (e.g., minor children) to potentially share in the trust income via gifts from the income beneficiary, which the grantor may not have intended.

Another significant disadvantage of a QSST election is the limitation of only one income beneficiary for the trust. This prevents use of the QSST election in common bypass or family structures. Note however, QTIP trusts generally qualify for QSST treatment due to having the surviving spouse as the sole income beneficiary and restrictions on distributions to others during the surviving spouse's life.

THE QSST ELECTION

Code Section 1361(d)(2)(A) requires the current income beneficiary of the trust to make the QSST election. The QSST election is due within two months and 16 days following the transfer of the S corporation stock to the trust and is revocable only with the consent of the Secretary. (Code Section 1361(d)(2)(C)–(D)). Additionally, a separate election must be made by the beneficiary with respect to each S corporation in which the trust owns stock. (Code Section 1361(d)(2)(B)(i)).

Under Treas. Reg. 1.1361-1(j)(6)(ii), the QSST election must be in a form or statement that:

- Contains the name, address and taxpayer identification number of the current income beneficiary, the trust and the S corporation;
- Identifies the election as an election made under Code Section 1361(d)(2);
- Specifies the date on which the election is to become effective (not earlier than 15 days and two months before the date on which the election is filed);
- Specifies the date (or dates) on which the stock of the S corporation was transferred to the trust; and
- Provides representations that the trust meets all of the requirements of a QSST under Code Section 1361(d)(3).

Part III of IRS Form 2553, Election by a Small Business Corporation, is used to make the QSST election only if stock of the corporation has been transferred to the trust on or before the date on which the corporation makes its election to be an S corporation.

ELECTING SMALL BUSINESS TRUST (ESBT)

ESBTs were created by the Small Business Job Protection Act of 1996 as a more flexible alternative to QSSTs. Unlike a QSST, an ESBT may have multiple beneficiaries and accumulate income.

Each "potential current beneficiary" of an ESBT must be an eligible S corporation shareholder and will count towards the 100-shareholder limit. (Code Section 1361(c)(2)(B)(v)). Note, however, an ESBT may have nonresident alien as a potential current beneficiary. (Treas. Reg. 1.1361-1(m)(1)(ii)(D)).

A potential current beneficiary generally includes any person who during the relevant period is entitled to or may receive at the discretion of any person a distribution from the income or principal of the trust. (Code Section 1361(e)(2)). For example, with a bypass trust, the surviving spouse and each living descendant will count as a potential current beneficiary.

The price for this flexibility is that, unlike a QSST, the ESBT is treated as a separate taxpaying entity with respect to the S corporation stock, which adds administrative complexity and a potentially higher tax liability on the S corporation income. Specifically, an ESBT is effectively split into two trusts for tax purposes with one "trust" holding only the stock in one or more S corporations and a separate "trust" holding the remaining assets. (Code Section 641(c)(1)).

The "trust" holding the S corporation stock pays tax on the S corporation income at the maximum marginal rate for individuals. (Code Section 641(c)(2)(A)). Importantly, this tax is paid at the trust level and at the highest rate even if the trust subsequently makes corresponding distributions to the beneficiaries. (Code Section 641(c)(2)(C)).

There is an additional restriction on qualification as an ESBT, which provides that no interest in the trust may have been acquired by a purchase. (Code Section 1361(e)(1)(A)(ii)). A purchase for this purpose is defined as any transaction in which the acquirer takes a cost basis under Section 1012. (Code Section 1361(e)(1)(C)). It is important to note that this restriction does not disallow the ESBT from acquiring stock in an S corporation by purchase.

The ESBT Election

The trustee of the trust, not the beneficiaries, makes ESBT election, which is only revocable with the consent of the Secretary. Unlike the QSST election, a single ESBT election covers all transfers of S corporation stock to the electing trust. (Treas. Reg. 1.1361-1(m)(2)(i)). Under Treas. Reg. 1.1361-1(m)(2)(ii), the ESBT election must be in a statement that includes:

- The name, address and taxpayer identification number of the trust, the potential current beneficiaries and the S corporation(s) in which the trust owns stock;
- An identification of the election as an ESBT election under Section 1361(e)(3);
- The first date on which the trust owned stock in each S corporation;
- The date on which the election is to become effective; and
- Representations signed by the trustee stating that the trust meets the requirements of Section 1361(e)(1) and that all potential current beneficiaries of the trust are eligible shareholders of an S corporation (except that a nonresident alien potential current beneficiary does not violate the requirement that all potential current beneficiaries be eligible shareholders).

The ESBT election has the same due date of two months and 16 days after the acquisition of S corporation stock as the QSST election. (Treas. Reg. 1.1361-1(m)(2)(iii)).

GRANTOR TRUSTS AND QUALIFIED REVOCABLE TRUSTS

All grantor trusts qualify as S corporation shareholders during the life of the owner and for a two-year period beginning on the date of the owner's death. (Code Section 1361(c)(2)(A)(ii)).

Additionally, a revocable management trust holding S corporation stock at the owner's death that makes an election under Code Section 645 to be taxed as part of the decedent's estate will continue to qualify as an S corporation shareholder until the later of (i) two years or (ii) the entire Section 645 election period. (Treas. Reg. 1.1361-1(k)(1), Example 3(ii)). A typical management trust is a "qualified revocable trust" as defined in Code Section 645 and may make an election to be taxed as part of the decedent's estate.

Further, because a revocable management trust with a Section 645 election in place is treated as part of the decedent's estate, the two-year automatic eligibility rule for testamentary trusts discussed above will apply to any trust receiving S corporation stock upon the grantor's death. (Id).

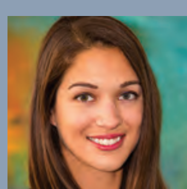
When a revocable management trust for a married couple holds S corporation stock, assets are typically divided between the deceased grantor's trust (for example, a bypass or family trust) and the surviving grantor's trust (a management trust for the surviving grantor) at the death of the first grantor. If the S corporation stock passes to the surviving grantor's trust, the trust will likely automatically qualify as an S corporation shareholder as a grantor trust to the surviving spouse.

If, alternatively, the S corporation stock passes to the deceased grantor's trust or different trust created upon the deceased grantor's death, additional steps will typically need to be taken to ensure that such trust can qualify as an S corporation shareholder. For example, QTIP marital deduction trusts created upon the deceased grantor's death meet all the requirements to qualify as an S corporation shareholder, either as a QSST or an ESBT. Additionally, a bypass or family trust can typically only qualify to make an ESBT election.

However, the bypass/family trust provisions sometime provide a "carve out" where the S corporation stock can be held in a separate and parallel trust that qualifies as either an ESBT or a QSST. In this case, the trustee would sever the trust into two separate trusts, one trust qualifying as a QSST/ESBT to hold the S corporation stock and another trust to hold the other assets.

The trustee (or beneficiary, as the case may be) can then make the appropriate election for the trust holding the S corporation stock. With respect to timing/advisability of the ESBT/QSST election, recall that if the distributing revocable management trust previously made a Section 645 election, the recipient trust will have automatic S corporation shareholder eligibility for up to two years from receipt of the S corporation stock.

Accordingly, when handling an estate administration with a revocable management trust and S corporation stock, it is vital to determine early on whether the stock was owned by the decedent individually or by the revocable management trust at death, and it is particularly important to be aware of whether or not a Section 645 election was made for the revocable management trust.



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LATE ELECTIONS

If a trust fails to timely file the appropriate QSST or ESBT election, the trust will fail to qualify as a permissible shareholder, which can have significant tax consequences, including causing the company to lose its S corporation status. The regulations provide that a corporation may generally seek relief under Section 1362(f) for inadvertent termination of an S election by submitting a private letter ruling request. (Reg. § 1.1362-4(c)). However, there is also a simplified proceeding to obtain a late QSST or ESBT election. (Rev. Proc. 2013-30, 2013-36 I.R.B. 173). This also applies to a late election for S corporation status as well.

Rev. Proc. 2013-30 provides general requirements for late election relief. Relief must be filed for within three years and 75 days after the intended effective date of the election. Additional general requirements include that the entity intended to have the election in place as of the intended effective date and that failure to qualify for the intended status was solely due to the late filing of the election.

ADDRESSING THE ISSUES

Handling an estate administration with S corporation stock can be tricky. While it cannot be emphasized enough that a thorough review of Code Section 1361 is necessary when a decedent owns S corporation stock, hopefully this article provides a basic and practical starting point in addressing these issues as the practitioner works through the estate administration process.

Additional content is available! Go to TXCPA's website for reference guides for QSST and ESBT requirements, the time period as eligible shareholder for estates and trusts, and requirements for filing a late QSST election.

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CURRICULUM:
Accounting and Auditing

LEVEL:
Basic

DESIGNED FOR:
CPAs in public practice

OBJECTIVES:
To explain and help remediate some of the unknowns surrounding reporting requirements for the Report of Foreign Bank and Financial Accounts, commonly called the FBAR

KEY TOPICS:
Filing requirements, U.S. Supreme Court case of *Bittner v. United States*, how penalties are assessed, interpreting the law, the difference between a "willful" and "nonwillful" violation, and what is reasonable cause

PREREQUISITES:
None

ADVANCED PREPARATION:
None

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What's Old is New(s):

Recent Developments in Foreign Bank Account Reporting

BY KIRK WONIO, CPA, DENTON LUNSFORD, CPA, AND SARAH WINGBERMUEHLE

For most CPAs, when a client shares that they have foreign activity, the immediate reaction can be one of anxiety at the thought of adding more reporting requirements to the already long list of domestic filing obligations. But knowledge dispels fear and in the following paragraphs, one particular reporting requirement will be explained and hopefully remediate some of the unknowns surrounding foreign reporting, specifically the Report of Foreign Bank and Financial Accounts (commonly called the FBAR).

In this article, the recent U.S. Supreme Court case of *Bittner v. United States* will be explored to better understand how penalties (often tens of thousands of dollars, if not hundreds of thousands) are assessed, the catastrophic differences a single word (or absence thereof) can make when interpreting the law, and how the difference between a "willful" and "nonwillful" violation could mean jail time. It is always a good idea to build our knowledge on a good foundation and answer the first question – what is an FBAR?

FILING REQUIREMENTS

The Foreign Bank and Financial Accounts Report (FBAR) was brought about by the Bank Secrecy Act (BSA) of 1970 to fight money laundering, tax evasion and other criminal activities.[i] A United States person (citizen, resident, corporation, partnership, LLC, trust, estate) must file an FBAR if they have a financial interest in or signature authority over at least one foreign financial account located outside the United States.[ii] Financial interest is defined as having ownership of records or holding legal title or you have sufficient interest in the entity.[iii] Signature authority means having authority to control the disposition of assets in the account by direct communication with the financial institution maintaining the account.

A foreign financial account is a financial account located outside of the United States.[iv] A financial account includes:

- Bank accounts, such as savings and checking accounts and time deposits;

A United States person (citizen, resident, corporation, partnership, LLC, trust, estate) **must file an FBAR if they have a financial interest in or signature authority over at least one foreign financial account located outside the United States.**

- Securities accounts, such as brokerage accounts and securities derivatives;
- Commodity futures or options accounts, insurance or annuity policies with a cash value, mutual funds; and
- Any other account maintained by a foreign financial institution.[v]

It is the location of the account, not the nationality of the financial institution, that determines whether an account is considered a foreign financial account for FBAR purposes.[vi]

The aggregate value of all foreign financial accounts must exceed $10,000 at any time during the calendar year in order to have an FBAR filing requirement.[vii] To determine if the account meets the reporting threshold, take the maximum value in the account in its local currency and convert it to USD using the year-end exchange rate.[viii] Even if the maximum amount was reached halfway through the year, the year-end exchange rate (as prescribed by the Treasury's Financial Management Service) is used.

FBARs are technically due on April 15 but are automatically extended to October 15 without request.[ix] FBARs are filed on Form 114 through the Financial Crimes Enhancement Network, or FinCen, through the U.S. Treasury Department. To fulfill the filing requirements, U.S. persons must complete and timely file the FBAR and answer the FBAR-related questions on their federal tax returns.[x]

The most common 2022 forms and questions are found here:

- 7a and 7b on Form 1040, Schedule B;
- 3 on Form 1041, page 3;
- 8 on Form 1065, Schedule B;
- 6a and 6b on Form 1120, Schedule N.

The answers to these questions on the federal tax forms could be critical in determining "willfulness."

PENALTIES

Those who fail to file an FBAR or those who fail to file a timely, complete and correct FBAR may be subject to the civil or criminal penalties. The intensity

Table 1. Penalty Structure

Violation	Civil Penalties	Criminal Penalties	References
Negligent Violation	Up to $1,078	N/A	31 U.S.C. §5321(a)(6)(A) 31 C.F.R. 103.57(h) Does not apply to individuals
Non-Willful Violation	Up to $12,459 for each negligent violation	N/A	31 U.S.C. §5321(a)(5)(B)
Pattern of Negligent Activity	In addition to penalty under §5321(a)(6)(A) with respect to any such violation, not more than $83,864	N/A	31 U.S.C. §5321(a)(6)(B) Does not apply to individuals
Willful - Failure to file FBAR or retain records of account	Up to the greater of $124,588 or 50% of the amount in the account at the time of the violation	Up to $250,000, 5 years imprisonment, or both	31 U.S.C. §5321(a)(5)(C) 31 U.S.C. §5322(a) 31 C.F.R. §103.59(b) for criminal This penalty applies to all U.S. persons.
Willful - Failure to File FBAR or retain records of account while violating certain other laws	Up to the greater of $100,000 or 50% of the amount in the account at the time of the violation	Up to $500,000, 5 years imprisonment, or both	31 U.S.C. §5322(b) 31 C.F.R. §103.59(b) for criminal This penalty applies to all U.S. persons.

Table 2. Characteristics of Violations and Reasonable Cause

	Willful	Nonwillful	Reasonable Cause
Penalties	Civil and Criminal	Civil	None
Examples	Signing tax return and incorrectly marking Schedule B Not filing FBARs when knowledge of requirement exists Exclusion of reportable income from foreign accounts Intentionally concealing foreign accounts Recklessly avoiding knowledge of foreign filing requirements	Unaware of filing requirements Filed accurate and complete reports upon knowledge of filing requirements	Person was not fully aware of filing requirements nor would they be expected to given their specific circumstances and they performed due care with regards to the facts at hand

CPE

of violation relies upon whether "willfulness" is assessed. Table 1 illustrates the penalty structure. The financial penalties are indexed each year for inflation. Imprisonment is introduced into the penalty structure once "willful" behavior is determined.

RECENT LITIGATION – *BITTNER V. UNITED STATES*

FBAR filing hit the headlines recently due to the finalizing of the *Bittner v. United States* Supreme Court case in February. Bittner, a dual citizen of Romania and the United States, filed delinquent FBARs, upon realizing the filing requirement, for the five calendar years covering 2007 through 2011 and 272 accounts were reported over the span of those five years.

The government accepted Bittner's filings as accurate and classified them as nonwillful late filings. Since the filings were not reported timely, the government assessed a late filing penalty in the amount of $2.72 million ($10,000 per account). And this was the question at hand: should the penalty be assessed on a per account or per filing basis?

For Bittner, the stakes were high. Assessing the penalties on a per account versus per filing basis had dramatic consequences - over a $2 million difference. The opinion of the Court outlines three main points why it should be per filing (favorable to Bittner). When interpreting the law, the Supreme Court first draws attention to the idea of "expressio unius est exclusio alterius;" that is, "the expression of one thing is the exclusion of the other." The Court relies heavily upon this idea to distinguish the difference in the wording used to assess willful versus nonwillful penalties. 31 U.S.C. §5314 authorizes the Secretary of the Treasury to impose the $10,000 nonwillful penalty, but it does not explicitly state whether or not the penalty should be per account or per FBAR for a nonwillful violation.

Interestingly, 31 U.S.C. §5321 does specifically address willful violations and deems those to be penalized on a per account basis.[xi] The Court chose to highlight this distinction in the language to support the idea that the penalties should be assessed differently for willful and nonwillful violations.

Per the opinion of the Court, Congress chose to use specific verbiage expressing that willful penalties should be calculated based on a per account basis. Therefore, this indicates that the exclusion of such specific language when describing nonwillful penalties lends to the idea that they should not be assessed on a per account basis, but rather per filing.[xii]

The aggregate value of all foreign financial accounts must exceed $10,000 at any time during the calendar year in order to have an FBAR filing requirement. To determine if the account meets the reporting threshold, take the maximum value in the account in its local currency and convert it to USD using the year-end exchange rate.

The next point of reference to support the opinion the Court employs is the abundance of affirming official literature. The Court found it compelling to express that the communications from the government concerning nonwillful FBAR penalties always state that the penalties shall not exceed $10,000.

In various IRS letters, Department of the Treasury notices, IRS "Fact Sheets," etc., the idea is represented that the nonwillful penalty shall not exceed $10,000 and makes no reference to the number of accounts, nor should it be a multiplying penalty. These guiding communications confer the conclusion that the penalty should be on a per filing basis.[xiii]

Lastly, the Court expresses the rule of lenity, which is defined as the principle that when the law is unclear, the Court should apply the law in a way that is favorable to the individual and unfavorable to the state or government. The Court agreed that the ambiguity of the FBAR penalty rules were compelling enough to employ the rule of lenity. Using "a dose of common sense," the Supreme Court reversed the judgment of the Fifth Circuit and declared that the penalty should be $10,000 per filing, thus ruling favorably for Bittner.[xiv]

The *Bittner v. United States* case has solidified the gray area around nonwillful penalties and brought much clarity to the BSA's overall intent for FBARs. The FBAR rules were designed to fight criminal activity, not to maximize revenue.

The main driver behind Bittner's case was the fact that he was found to be nonwillful in his late filings without reasonable cause. It was on this point that all the Courts agreed. If Bittner had been found willful, assessing the penalties would have been simple enough.

In contrast, had Bittner been able to prove "reasonable cause" for his late filings, he could have avoided penalties altogether. These three circumstances are worth diving into further - how does the Court define willful versus nonwillful violations and what is considered reasonable cause?

WILLFUL VS. NONWILLFUL

With no clear definition of willfulness available, recent Court cases can be a valuable tool when understanding how the courts declare a violation willful. In the case *United States v. Warner*,[xv] the Court found Warner's violation to be willful due to:

- The exclusion of the interest income generated by the offshore accounts on his individual tax return;
- Fraudulently stating on his tax return that he had no foreign accounts (Federal Form 1040, Schedule B, line 7a); and
- Failing to file an FBAR form.

Similarly, in *United States v. Ott*,[xvi] the Court found Ott was willful based on the following facts:

- He had constructive knowledge of his reporting requirements by signing his tax returns (which included marking the Schedule B question "no");
- He listed his sister's Canadian address on the foreign accounts rather than his U.S. address to redirect any paper statements generated by the accounts and thus committed an act of concealment; and
- The account balances of the foreign accounts represented a large portion of his overall wealth, which demonstrated that he recklessly failed to file the FBARs.[xvii]

One thing all the Courts agreed on with regards to the Bittner case was that it was a nonwillful violation. As with willfulness, the IRS does not give us a clear definition of what it means to be nonwillful. However, in the case of Bittner, the Court agreed to accept his violation as nonwillful since he was unaware of his filing requirements. This was supported by the fact that he hired a CPA and began filing all the necessary returns and reports upon his re-entrance to the U.S. in 2012.

Being nonwillful did not dispense Bittner from penalties altogether, but it did relieve him of any possible criminal penalties – and per account penalties!

REASONABLE CAUSE

The only way to avoid penalties altogether is to establish reasonable cause for nonwillful violations. The Fifth Circuit stated that reasonable cause "requires showing that the individual exercised ordinary business care and prudence, considering all pertinent facts and circumstances on a case-by-case basis."[xviii]

In Bittner's defense, he stated that he filed the returns as soon as he became aware, but when asked why he hadn't inquired about the filing requirements sooner, he responded that he "didn't feel like it."[xix] Obviously, this was not a very compelling response.

The Court also observed that Bittner was a sophisticated business professional with business dealings with the Romanian government, had transferred assets to holding companies, and invested in various industries and European countries. With his overall business acumen, the Court denied Bittner's request for reasonable cause and made him subject to the nonwillful penalties.

Table 2 summarizes some characteristics of willful and nonwillful violations and reasonable cause.

ACTION ITEMS

There are a few options available for taxpayers with undisclosed foreign financial assets. The first option available to taxpayers is the Voluntary Disclosure Practice (VDP). The VDP is a practice of IRS Criminal Investigation (CI) and is not limited to FBARs.[xx]

A voluntary disclosure occurs when a truthful, timely and complete disclosure is provided to CI.[xxi] Individuals going through the VDP must fill out Part I of Form 14457, *Voluntary Disclosure Practice Preclearance Request and Application*.[xxii] Once individuals receive preclearance, they are able to fill out Part II of the application.

Second is the Streamlined Filing Compliance Procedures. The Streamlined Filing Compliance Procedures are specifically designed for nonwillful delinquent or incorrect FBARs. This program allows taxpayers with unreported income related to the foreign accounts to file amended tax returns and delinquent FBARs and resolve their tax and penalty obligations.[xxiii]

The IRS outlines the specific eligibility requirements for both non-U.S. residents and U.S. residents. In both cases, taxpayers must certify that conduct was not willful and pay any previous penalty assessments.[xxiv] If the IRS has initiated a civil examination or a criminal investigation, the taxpayer is not eligible for the streamlined programs.

Lastly, if a U.S. person has no unreported income and learns they should have filed an FBAR for an earlier year, they can electronically file a late FBAR through the BSA.[xxv] An individual will include an explanation for the late filing on Form 114 and indicate whether the filing is made in conjunction with an IRS compliance option.[xxvi] If the IRS assesses the violation was due to reasonable cause, no penalty will be imposed.

IN SUMMARY – FBAR FILING REQUIREMENTS

If a client has foreign accounts, it is always best practice to inform them of the potential of FBAR filings. Remember, if the aggregate highest balance of foreign accounts exceeds $10,000, there is a filing requirement. The penalties, indexed for inflation, start in the thousands of dollars and go up from there with the potential for jail time if the filing is willfully violated.

The Courts take FBAR filing very seriously, as shown in the Bittner case with the nonwillful violation and the Warner and Ott cases that had willful violations.

CPE

It is always in the client's best interest to keep detailed records of all foreign activity and report when necessary. Assisting clients with these reporting efforts can be a crucial service considering the consequences. Let the question on Schedule B of the 1040 serve as an opportunity to discuss these reporting obligations with clients, offering that second mile of service, and ensuring quality and compliance remain in the forefront of the return preparation.

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FOOTNOTES

[i] 31 U.S.C §5311(4)
ii 31 U.S.C. §5316
[iii] Id.
[iv] Department of the Treasury and Internal Revenue Service. "Report of Foreign Bank & Financial Accounts" Publication 5569 (Rev. 3-2022) 2.
[v] Id.
[vi] Id.
[vii] 31 U.S.C. §5316(a)(1)
[viii] Department of the Treasury and Internal Revenue Service. "Report of Foreign Bank & Financial Accounts" Publication 5569 (Rev. 3-2022) 3.
[ix] Id.
[x] Id.
[xi] 31 U.S.C. §5314(a)(5)(D)(ii)
[xii] Bittner v. U.S. 598 U. S. 1 (2023)
[xiii] Id.
[xiv] Id.
[xv] U.S. v. Warner No. 14-1330 (7th Cir.2015)
[xvi] U.S. v. Ott 441 F. Supp. 3d 521 (E.D. Mich. 2020)
[xvii] U.S. v. Ott 441 F. Supp. 3d 521 (E.D. Mich. 2020)
[xviii] U.S. v. Bittner No. 20-40597 (E.D. Tex. 2021)
[xix] Id.
[xx] "IRS Criminal Investigation Voluntary Disclosure Practice." Internal Revenue Service. IRS.gov
[xxi] Id.
[xxii] Id.
[xxiii] "Streamlined Filing Compliance Procedures" Internal Revenue Service. IRS.gov
[xxiv] Id.
[xxv] Department of the Treasury and Internal Revenue Service. "Report of Foreign Bank & Financial Accounts" Publication 5569 (Rev. 3-2022).
[xxvi] Id.
[xxvii] 31 U.S.C §5311(4)
[xxviii] 31 U.S.C. §5316
[xxix] Id.
[xxx] Department of the Treasury and Internal Revenue Service. "Report of Foreign Bank & Financial Accounts" Publication 5569 (Rev. 3-2022) 2.
[xxxi] Id.
[xxxii] Id.
[xxxiii] 31 U.S.C. §5316(a)(1)
[xxxiv] Department of the Treasury and Internal Revenue Service. "Report of Foreign Bank & Financial Accounts" Publication 5569 (Rev. 3-2022) 3.
[xxxv] Id.
[xxxvi] Id.
[xxxvii] 31 U.S.C. §5314(a)(5)(D)(ii)
[xxxviii] Bittner v. U.S. 598 U. S. 1 (2023)
[xxxix] Id.
[xl] Id.
[xli] U.S. v. Warner No. 14-1330 (7th Cir.2015)
[xlii] U.S. v. Ott 441 F. Supp. 3d 521 (E.D. Mich. 2020)
[xliii] U.S. v. Ott 441 F. Supp. 3d 521 (E.D. Mich. 2020)
[xliv] U.S. v. Bittner No. 20-40597 (E.D. Tex. 2021)
[xlv] Id.
[xlvi] "IRS Criminal Investigation Voluntary Disclosure Practice." Internal Revenue Service. IRS.gov
[xlvii] Id.
[xlviii] Id.
xlix "Streamlined Filing Compliance Procedures" Internal Revenue Service. IRS.gov

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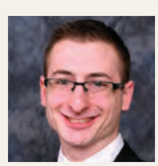

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Continued on page 42

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