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Today's CPA

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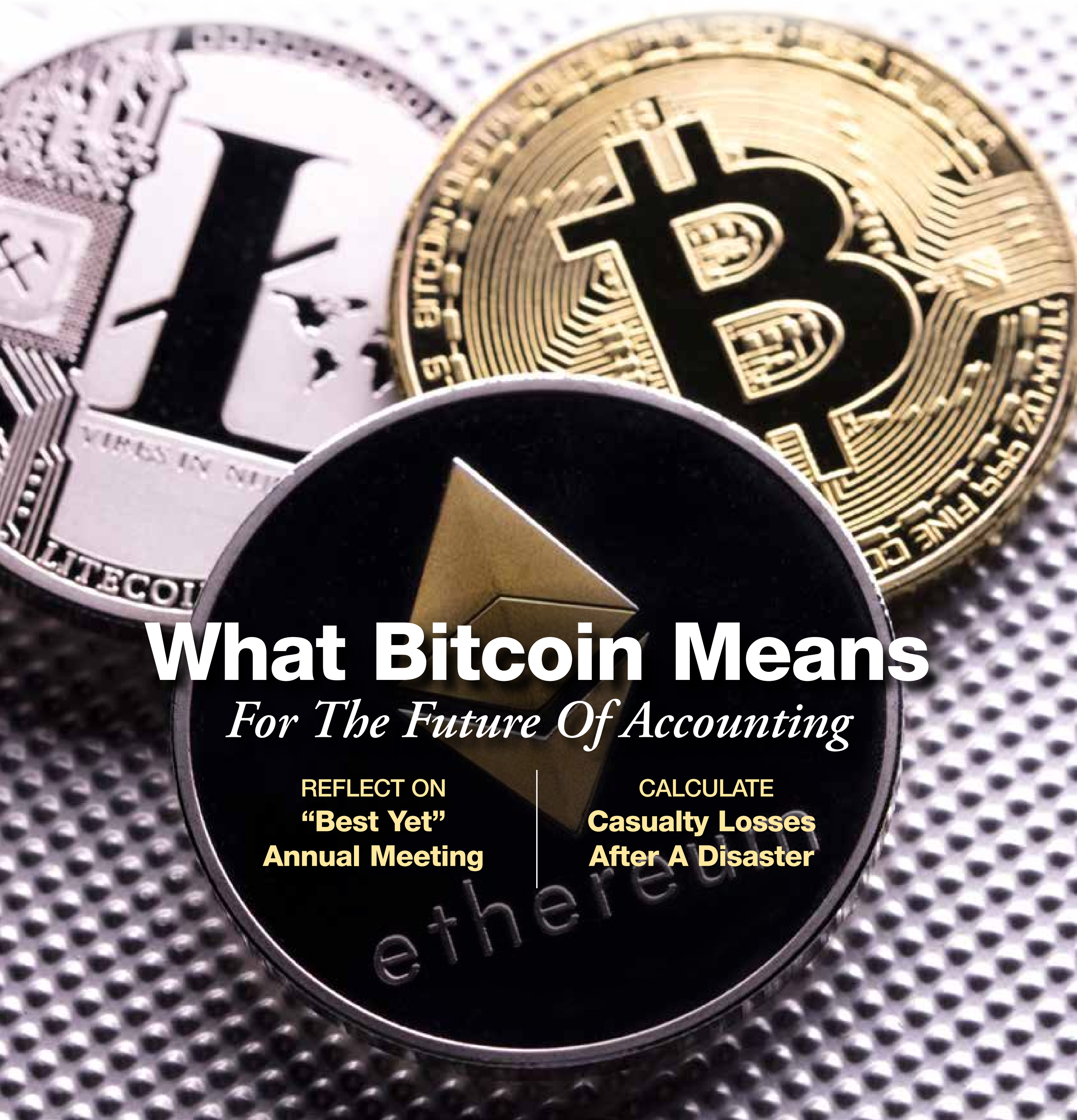

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Let me know what you think!

I want to hear your feedback and questions during my chairmanship at TSCPA. Drop me a note at chairman@tscpa.net. I'd love to hear from you!

Leveraging Technology To Deliver *Today's CPA*

By TSCPA Chairman **STEPHEN PARKER**, CPA-Houston

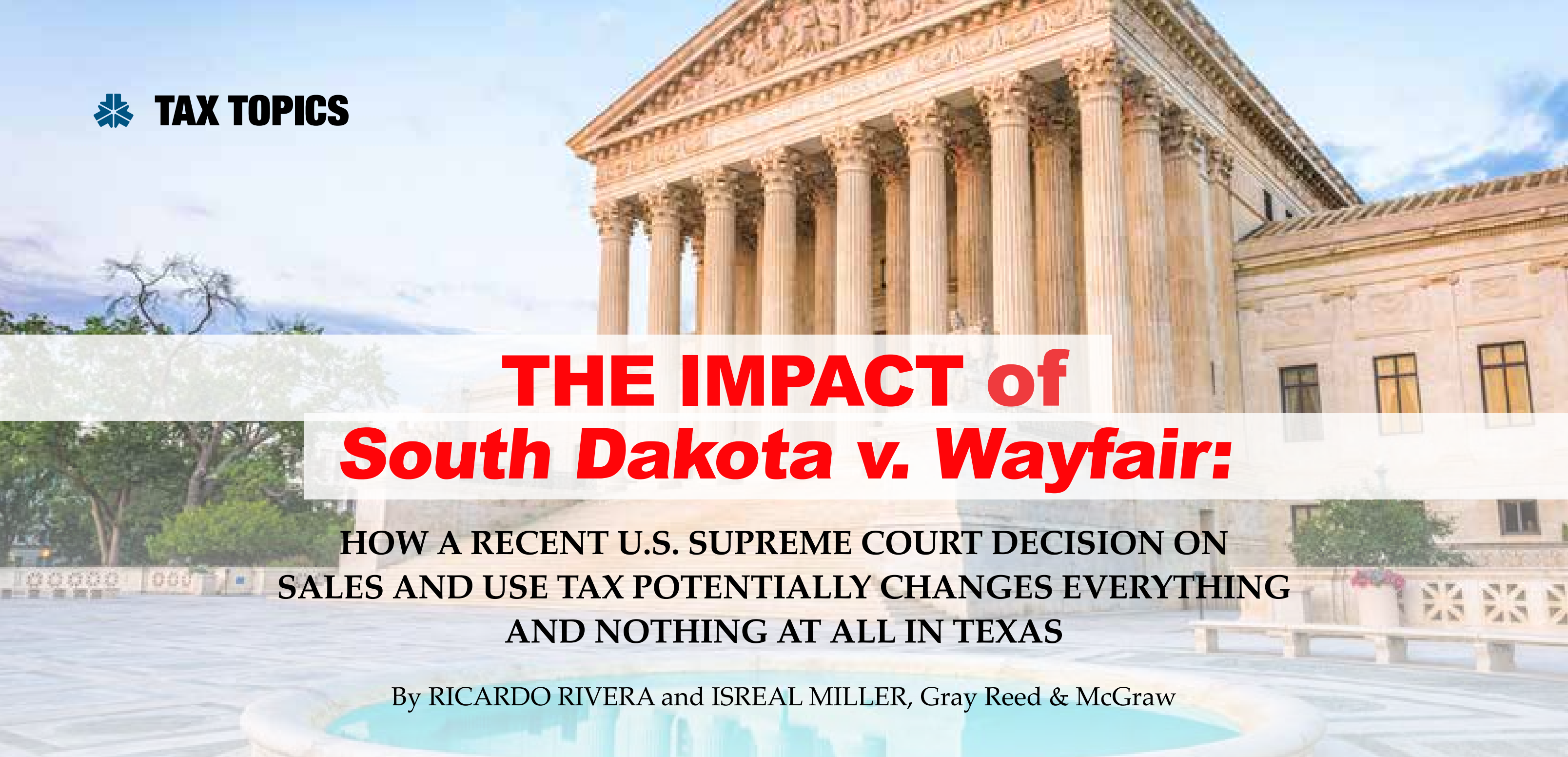
Welcome to the first digital-only issue of *Today's CPA*! Two of our six annual issues will be delivered in this specific digital format. The other four will arrive in your mailbox in print format, in addition to being posted online for those who prefer to read their publication on the go.

Empowering you to lead and succeed is at the heart of TSCPA's work. We understand the importance of keeping you connected and informed of the latest professional news, insights and resources. This digital issue is one of many new ways we are leveraging and leading in technology for the delivery of your benefits.

The digital magazine includes all the same compelling editorial content of the print magazine issues, but offers it in a convenient, interactive and mobile-friendly experience. You can access content anytime, anywhere on your laptop PC, desktop PC and mobile devices. No matter where you are during the day, *Today's CPA* will be at your fingertips. You'll also receive your magazine more quickly than you can with print - no need to wait for it to arrive in the mail.

We're excited to offer your magazine in this new format. Get started now to instantly read the professional news and commentary you've come to expect from *Today's CPA.*

Stephen Parker, CPA is a partner in PwC's Houston assurance practice. He can be contacted at stephen.g.parker@pwc.com.



THE IMPACT of *South Dakota v. Wayfair:*

HOW A RECENT U.S. SUPREME COURT DECISION ON SALES AND USE TAX POTENTIALLY CHANGES EVERYTHING AND NOTHING AT ALL IN TEXAS

By RICARDO RIVERA and ISREAL MILLER, Gray Reed & McGraw

On June 21, 2018, the United States Supreme Court ruled that states can compel online retailers to collect and remit sales tax to states in which those retailers have no physical presence. This was a historic decision, as it puts brick-and-mortar retailers on a more "equal footing" with their online competitors to the extent that the latter will also have to collect and remit sales tax.

What follows is a brief review of the significance of the Supreme Court's decision in this tax case, involving South Dakota, the current sales and use tax rules in Texas, and the impact that this case might have on future tax legislation in the Lone Star State.

So Why All the Fuss About *South Dakota v. Wayfair?*

In *South Dakota v. Wayfair*, No. 17-494, (decided June 21, 2018) the United States Supreme Court overturned its 1992 decision in *Quill v. North Dakota*, a case that indicated a physical presence in a state was required for the state to constitutionally impose an obligation on a retailer to remit sales and use tax to that state.

The Wayfair case specifically involved South Dakota's "economic nexus law," which obligates out-of-state sellers to collect and remit sales tax if they have more than $100,000 of annual sales into the state or, in the alternative, more than 200 in-state transactions. South Dakota is not the only state with a law that has an "economic nexus model" and imposes an obligation on out-of-state sellers that exceed certain gross sales or transaction thresholds to collect and remit sales tax. There are approximately 20 other states with similar laws. Of those, only Tennessee, Washington and Wyoming do not impose a state income tax.

Although Wayfair may be a sign of changing times, typically Texas does not tend to be an early adopter of new ideas. It has yet to enact a law or adopt a regulation that creates taxable nexus based strictly on economic activity. "Nexus" exists when a company has sufficient contact with, or activity within, a state to require that person or entity to remit sales and use tax to that state. Texas currently requires some degree of activity in the state before requiring online and out-of-state retailers to remit sales and use tax.

Sales to Texas Residents

If a business operates online or out-of-state, does it have to collect and remit sales tax on sales to Texas residents? Unfortunately, it depends on a number of factors. Texas imposes a sales tax on the sale of tangible personal property and taxable services in the state. Items that are purchased outside of Texas, but stored, used or consumed in the state, are taxed to the purchaser via a use tax.

A seller's activity in Texas will give rise to an obligation to collect and remit sales tax if it has a "place of business" in Texas, because the seller will clearly have nexus in the state. A seller that does not have a place of business, but is otherwise "engaged in business" may also have an obligation to collect and remit sales tax in Texas. These two scenarios might seem easy to distinguish, but many retailers do not think they have a place of business in Texas when they actually do and even more sellers that do not have a place of business are otherwise "engaged in business" in Texas, but don't know it! How is this possible?

A place of business is typically an office, an outlet or any kind of physical location operated by the seller. Although these examples might seem obvious, what constitutes a "place of business" under Texas law is quite broad. For example, a home office out of which three or more items are sold through an online auction website is a place of business. This example is part of the definition of "place of business" included in the Texas Administrative Code. Such sellers might think that because they are operating online, they do not have a "place of business" in Texas, but they would be mistaken.

The Texas Tax Code provides additional context by establishing rules that allow online and out-of-state sellers to determine where a sale is deemed to occur and, consequently, if they have an obligation to collect and remit Texas sales tax. For example, the Texas Tax Code indicates that a seller is obligated to collect sales tax on taxable items delivered to customers in Texas if the goods sold are either stored or delivered from a location in Texas. This explains why online and out-of-state sellers that sell goods via an Amazon Fulfillment Center within the state have to collect and remit sales tax on all sales made to buyers in Texas.

Companies that are not already calculating, collecting and remitting sales tax for their online sales may have to update their systems to add this capability in Texas and other states where they have sales.

Even without a "place of business," an online or out-of-state seller might still be "engaged in business" in Texas. The Texas Administrative Code defines what it means to be "engaged in business" in Texas by providing numerous examples. Some of the examples in the statute, like "maintaining an office in the state," make it clear that the seller is engaged in business in Texas and thus has to collect and remit sales tax. Other examples, such as "allowing a franchisee or licensee to operate under its trade name in this state if the franchisee or licensee is required to collect sales or use tax in this state," are less intuitive.

Section §151.107(a)(5) of the Texas Tax Code imposes on online and out-of-state sellers an obligation to collect sales and use tax without establishing either gross receipts or transactional activity thresholds that would constitute "economic nexus" under Wayfair. The statute indicates:

"[A] retailer is engaged in business in this state if the retailer…(5) solicits orders for taxable items by mail or through other media and under federal law is subject to or permitted to be made subject to the jurisdiction of this state for purposes of collecting the taxes imposed by this chapter"

This language ostensibly imposes on all online and out-of-state sellers with customers in Texas an obligation to collect and remit sales tax by deeming them to be "engaged in business" in the state regardless of their level of activity.

An online or out-of-state seller that is deemed to be "engaged in business" in Texas has to obtain a sales and use tax permit from the Texas Comptroller and would be responsible for collecting and remitting sales and use tax until it ceases to have "nexus."

Why Worry Now?

Unlike South Dakota, Texas has yet to enact a law or adopt a regulation that creates nexus based strictly on economic activity and whether or not such a statute will be adopted in the next legislative session is anybody's guess. That said, there are those who believe that such legislation is not needed. The current Texas Comptroller of Public Accounts, the Honorable Glenn Hegar, issued a memo dated July 5, 2018, in which he stated:

"With appropriate notice, and prior to legislative action, Tax Code § 151.107(a)(5) (Retailer Engaged in Business in the State) could be imposed on remote sellers to the extent they "[solicit] orders for taxable items by mail or through other media," meaning, for example, sellers who solicit sales in Texas through catalogs and emails."

Simply put: The Texas Comptroller believes that both online and out-of-state sellers have an obligation to collect and remit Texas sales tax under the current statutory framework. The lack of a gross sales or transaction threshold might expose the current framework to legal challenges such as the one South Dakota faced in the Wayfair case. The Comptroller anticipates this, as his memo also indicates, "we are reviewing agency rules that need amending to … explain the amount of economic nexus in sales and/or transactions required to create a safe harbor for small sellers."

It probably does not bode well for online and out-of-state sellers because, like South Dakota, Texas does not impose a state income tax and relies heavily on sales and use tax revenue to fund essential services. According to an article published on July 9, 2018, in the online version of *The Dallas Morning News*, in 2014, the former Comptroller estimated that Texas could gain more than $1 billion in combined state and local taxes if internet sales were taxed. While this number might have gone down given that large online sellers like Amazon are currently collecting and remitting Texas sales tax, we believe that we will see increased efforts to enforce existing rules and guidelines that apply to online and out-of-state sellers as Texas tries to increase sales and use tax collections.

Overall, the U.S. Supreme Court's decision in Wayfair serves as both a reminder of existing obligations and a sign of things to come for taxpayers doing business in Texas.

Next Steps

The Texas Comptroller indicated that there would be no retroactive application of the new law to remote sellers that have no physical presence in the state. Nevertheless, his office is currently reviewing statutes that may need to be updated when the legislature convenes in 2019 in light of the Wayfair decision.

In the meantime, companies that are not already calculating, collecting and remitting sales tax for their online sales may have to update their systems to add this capability in Texas and other states where they have sales regardless of physical presence. This could represent a significant challenge to mid-size businesses that will fall under the minimum presence thresholds and are not already collecting sales information and filing the necessary returns. Even companies with mostly nontaxable sales may be required to register for sales tax purposes and collect certificates to support any untaxed sales in the event of an audit.

Regardless of whether there is an actual "place of business" in Texas or someone operates remotely, but is "engaged in business" in the state, it is critical to comply with sales and use tax reporting and remittance requirements. It is best for businesses to work with a tax professional who can provide the guidance to help them get up to date with their obligations and minimize their exposure to penalties and interest. ♣

ABOUT THE AUTHORS

RICARDO RIVERA, COUNSEL, has broad experience in tax and corporate transactional matters. He has an extensive background in handling and structuring business transactions, partnership and corporate tax planning, and corporate governance in a variety of areas. Prior to joining Gray Reed, Rivera served as director & tax counsel for American Airlines, where he was in charge of federal taxes, international taxes with a focus on Latin America, and employee benefits and executive compensation issues. He received his JD, magna cum laude, from the University of Puerto Rico School of Law, and his LL.M. in Taxation with a Certificate in Employee Benefits Law from the Georgetown University Law Center. He is also a CPA and member of TSCPA. Contact him at rrivera@grayreed.com.

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WAYFAIR

SUPREME COURT RULING BRINGS SALES TAX COMPLIANCE CHALLENGES

In June, the U.S. Supreme Court decided what is arguably the most important state tax case of the last 25 years in *South Dakota vs. Wayfair.*

The decision overruled the sales and use tax nexus standard of physical presence as it applied to South Dakota's sales/transaction-based sales and use tax nexus statutes affecting remote seller transactions, clearing the way for more sales tax revenue from internet purchases.

To help TSCPA members keep informed and be ready to advise their employers and clients, several upcoming CPE webcasts are scheduled. **Register today!**

Webcast: Pay Up! Wayfair Creates Virtual Presence Standard

September 27
October 19
November 5
November 26
December 18
December 31

Going Public?

By **MANO MAHADEVA**, CPA, MBA, Column Editor

As an executive of a private company, you see real demand for your products. You know what your customers want and you truly feel you can meet their demands. Your company is growing fast. It is profitable and you have a competitive advantage over others in your category. Feeling confident, you want to join the other lively companies that have recently emerged on the public market. Congratulations!

You won't be alone. IPO volumes have been at high levels over the past three years! The stock turbulence has not stopped IPO stock from flying to new highs. For investors looking to capture sizable gains in today's market, your stock may be worth the pursuit.

True, you seem worried about all the issues that came about in early 2000, such as:

- the corporate scandals and reforms,
- increased scrutiny by regulators,
- the principal-agent problem,
- activist involvement,
- short termism, and
- all the high costs of remaining public.

Yes, these are concerns that remain, so you will have to ponder these against the benefits the present business climate offers your company.

An IPO is a traditional way to raise capital for your company. Doing so can provide a liquidity event to reward your team for their efforts since start up. Your company has gone through many acquisitions and mergers, and it is now the category leader. At the present, it has a dominant market position. The bull market shows no signs of slowing down, with very affordable liquidity.

Trade tensions between the United States and other countries have created some profitable opportunities for you to seize. Your company has sizable debt due to your merger and acquisition strategy, and you would like to use the public exit to pay down some of this to adequately balance your corporate capital structure. Your present investors want to extract high returns from you to show their present and potential investors their investment prowess.

A word of caution – going public is not for the faint of heart. This is a long process, followed by trailing expenses likely costing millions of dollars. You will pay roughly 7-8 percent of all dollars raised to the underwriter who sells your stock. If your stock is valued too low, you leave money on the table; if priced too high, your offering can be a flop. You will deal with investors creating false demand, only to flip the stock shortly after you go public. In doing so, this also open doors to short sellers and activist investors, creating distractions from your initial mission.

It is not unusual for companies to disappoint in the earnings reports soon after going public – think Twitter and Facebook. Your growth story may not materialize or it may take too long – like Blue Apron, the meal delivery kit company, or Snap, Inc., parent of Snapchat, which are still struggling to get past their initial value.

Well, it appears that I have not dissuaded you yet! Let's discuss some good rules of thumb related to building a healthy, sustainable and predictable business. Early preparation is key:

- run the company as if it were public at least a year prior,
- run the quarterly earnings process,
- have mock earnings calls, and
- track your guidance against actual results.

Forecasts need to be close to expectations, timely and accurate, with no negative surprises. Confirm accounting treatments and reconcile differences with your auditor. Clean up financial statements before you go public, as doing so after will be difficult.

Invest money in resources – people and systems – to build robust business infrastructure to make the company more efficient and profitable by supporting growth initiatives. Hire a quality management team that includes a CFO who can be the face to investors and analysts, and to help educate them on the business and build long-term relationships. Hire a quality banker and team with those you have established a deep relationship with that is built on trust and who is fully transparent with you during the entire process.

Address investor concerns by establishing best-in-governance practices and by recruiting qualified and capable independent board members who have time to serve.

Address investor concerns by establishing best-in-governance practices and by recruiting qualified and capable independent board members who have time to serve. Establish a top-down driven code of ethics and an investor relations strategy that will attract quality investors.

I get it that you are convinced that going public is best for your company. Everyone wants to invest in a company built to last. So, are you truly ready to share your intimate relationship with your share price with the public? ♣

ABOUT THE AUTHOR:

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

SEC Requires Greater Transparency On Companies' Efforts To Prevent Cyberattacks

By **DON CARPENTER**, MSAcc/CPA

It is now a regular occurrence to read of yet another company that has experienced a breach in its defenses against cyberattacks. Data such as confidential customer information is repeatedly compromised. The disclosure earlier this year that client information in Facebook had been "mined" and used by Cambridge Analytica in the most recent presidential election campaign made front page news. The incident dominated headlines as Facebook Chairman and CEO Mark Zuckerberg testified before Congress regarding steps his organization would take to remediate its systems and prevent similar breaches in the future.

Breaches in information technology systems can occur due to intentional malicious third-party efforts, negligence on the part of employees, or system glitches or failures. But regardless of the cause, the fallout of lapses in data security can be very costly and result in harmful consequences, including the following:

- Lost revenue due to customer defections and damage to market reputation,
- Costly settlements with those adversely affected and regulatory agencies,
- Remediation costs, such as systems upgrades and added personnel to prevent future attacks.

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

Given the ever-increasing automation and interdependence of business systems, the Securities and Exchange Commission (SEC) released interpretive guidance earlier this year that requires companies to include cybersecurity in their disclosure policies and procedures. It is important to distinguish the policies and procedures that companies adopt to detect and prevent system breaches from those that are the focus of the SEC release. The SEC is requiring companies to review and update disclosure policies and procedures that relate to their reporting obligations as public companies.

A review of the required risk factors in annual reports will indicate that most companies have determined that cybersecurity is material enough to warrant inclusion. However, the SEC is now saying that the reporting obligation extends beyond just describing the risks of cyberattacks. The guidance requires review of the following four areas of corporate governance.

1. Policies and Procedures

A registrant's disclosure obligations in its annual and quarterly reports require information from all parts of the organization. The financial statements form the backbone of the reports, but these are fleshed out in the footnotes and MD&A. To ensure that all relevant information is assimilated on a timely basis, detailed protocols are followed as the books are closed. For example, it is often standard practice for the reporting team to hold discussions with counsel to ascertain if disputes or litigation should be disclosed even if accruals are not required. Similar procedures are followed for other areas requiring potential disclosures.

Likewise, building a protocol to capture all relevant information regarding cyber occurrences and modifications the company has made to its technology security is now required. Documenting the company's decision regarding when and to the extent disclosure is necessary, as well as the concurrence of the company's audit firm on a timely basis, is also advisable.

2. Extent of Disclosure Obligations

The SEC also stressed that the disclosure obligation of registrants extends beyond the Risk Factor section of the annual report. Companies should consider the costs of cybersecurity measures, the frequency and costs of breaches and other incidents, and the potential for future incidents in the preparation of MD&A. To the extent that the costs and risks fall disproportionately among the reportable segments, this should also be disclosed.

The financial statement footnotes should align with the increased transparency of MD&A. The impact of cybersecurity incidents on revenue and the value of intangible customer relationships should be discussed, if material. In addition, settlement costs for disputes stemming from breach of contracts or indemnifications and insurance costs should be disclosed if material.

3. Board Oversight

The guidance also reminds registrants that the extent of its board of directors' participation in the oversight of risk is required to be disclosed. This disclosure is often included in the company's annual proxy statement.

As cybersecurity has continued to increase in materiality, companies may find it necessary to include a review of their cyber policies and procedures, as well as incidents, on the agendas of directors' meetings on a regularly recurring basis.

4. Reporting and Insider Trading

The SEC also included a reminder that directors, officers and other insiders must be mindful of rules relating to insider trading. It is illegal to trade in securities if one is in possession of material nonpublic information. Details about cybersecurity incidents could qualify as such information. And the disclosure of such information also falls within the purview of Regulation FD, which requires that any selective disclosure of nonpublic information must be made available to the investing public. In this context, it is also advisable to consider the use of Form 8-K that requires the disclosure of major or material events within four days of occurrence, with regard to cybersecurity issues.

The focus of the SEC on cybersecurity in the context of its reporting and disclosure framework confirms the increased importance and corresponding risks inherent in this vital part of organizations.

2017-2018 Outstanding Chapter Awards

To inspire chapters in their continuing work to elevate member service, TSCPA bestows Outstanding Chapter Awards to the small and medium-sized chapters. Selection is made by a group of past presidents from chapters of all sizes, who understand the work involved in successfully leading volunteers. Following is information about the chapters honored for the 2017-2018 year.

Outstanding Medium-sized Chapter: Central Texas
President: Nancy Miller, CPA, CGMA

To assist Mission Waco with their annual drive, the Young CPA Committee stepped in to fill a gap of 1,000 backpacks along with school needs and socks. Members stuffed the bags with the supplies and worked several shifts distributing backpacks to grateful parents. Because of the chapter's efforts, all eligible families were able to receive new backpacks and school supplies for their children to use on the first day of school.

Volunteers at the HEB Feast of Sharing – a community-wide free meal – totaled 29, including 19 who were new to the project. There was a 50 percent increase over the previous year's participation from the chapter. Volunteers seated people, worked in the serving line and brought plates to the tables. During the event, more than 6,500 individuals were given a warm, delicious meal and were entertained by various community groups.

CPA-PAC Awareness was promoted by having a speaker at every member event who talked about the benefits of contributing to the fund. At the large-audience CPE program, there was a CPA-PAC information table. PAC donations were 100 percent more than the previous year and the chapter received an award from TSCPA.

There was increased involvement in state-level leadership roles. A member served on the TSCPA Executive Board and four were Directors-at-Large. There were two chairs of state-level committees, with 19 chapter members volunteering.

Outstanding Small Chapter: Southeast Texas
President: Marylyn Byrd, CPA

Despite recovery from the area-wide devastation of Hurricane Harvey just a few weeks before, volunteers sold tickets to the annual scholarship fundraising luncheon. The event was a welcome respite for the 150 individuals who gathered to connect and enjoy the meal. Adding tiered donation levels brought in 50 percent more money from sponsorships than the year before. The total netted was a 6 percent increase. As a result of the fundraising, the chapter gave $7,000 in grants to three accounting majors at Lamar University. In addition, the chapter made a $1,000 contribution toward its endowed scholarship; that fund provided an additional bequest to a Lamar accounting student.

There was 10 percent growth in the number of individuals who donated to CPA-PAC. Member contributions exceeded the fundraising goal by 132 percent, the highest amount of all chapters. Personal outreach by the chapter committee chair was the key factor.

The chapter continued its culture of TSCPA involvement, with six members attending the Annual Meeting in Colorado Springs and eight at the Midyear Board of Directors and Members Meeting in Corpus Christi. For the fifth consecutive year, a member attended at least one of these meetings for the first time. A member served on the TSCPA Executive Board and two were Directors-at-Large. There were 10 members on 12 committees at the state level, an increase from the previous year.

Help Make Your Chapter Award-Winning

Members are the key to – and the reason for – chapter success. Contact your local president or executive director and find out how you can get involved in making yours an award-winning chapter! You can get contact information through the TSCPA website at www.tscpa.org.

TSCPA Thanks Strategic Partners – Goodman Financial and CPACharge

TSCPA would like to thank Goodman Financial and CPACharge, our 2018-19 Strategic Partners. Goodman Financial is a Texas-owned, fee-only investment management and financial advisory firm. CPACharge is a financial technology company that offers payment solutions made specifically for CPAs.

We believe these valuable partnerships will help advance our strategic vision to empower members to lead and succeed, and we appreciate their generous investment in our organization.

Interested in learning about how your organization can become a Strategic Partner? Find out more about the packages and options available through our Annual Partners Program here.

REGISTER NOW

Career Development Forum: Professional Peers Conference for CPAs Under 40

Join accounting professionals from across Texas on November 2 at the Kimbell Art Museum in Fort Worth for the Career Development Forum, a professional peers conference for CPAs under 40. The Fort Worth Chapter's Under 40 Professionals Group and TSCPA's Young and Emerging Professionals Committee are joining forces to host this one-day conference on challenges facing early- to mid-career professionals.

You'll hear from a talented and experienced group of peers as they discuss professional advancement, personal communication skills, work-life balance, and other challenges and opportunities facing young accounting professionals. The fee to attend is $130 and includes eight hours of CPE, free parking, an optional pre-conference reception, an optional post-conference tour or happy hour, and more. Additional details and registration information.

November is the Statewide CPA Month of Service

Are you looking for a great way to give back to your community? TSCPA and the Young CPAs and Emerging Professionals Committee for TSCPA are hosting the statewide CPA Month of Service this November. It's an ideal opportunity for members to help those in their community by participating in a volunteer activity of their choice. Members can register as an individual, get a group together in their firm or company, or volunteer with their TSCPA chapter.

More information about the CPA Month of Service is available here. If you have questions, please contact TSCPA's Catherine Raffetto at craffetto@tscpa.net or 800-428-0272, ext. 216 (972-687-8516 in Dallas). And don't forget to use the hashtag #TXCPAService to share your experiences.

TSCPA Seeks Faculty and Student Campus Ambassadors for 2018-2019

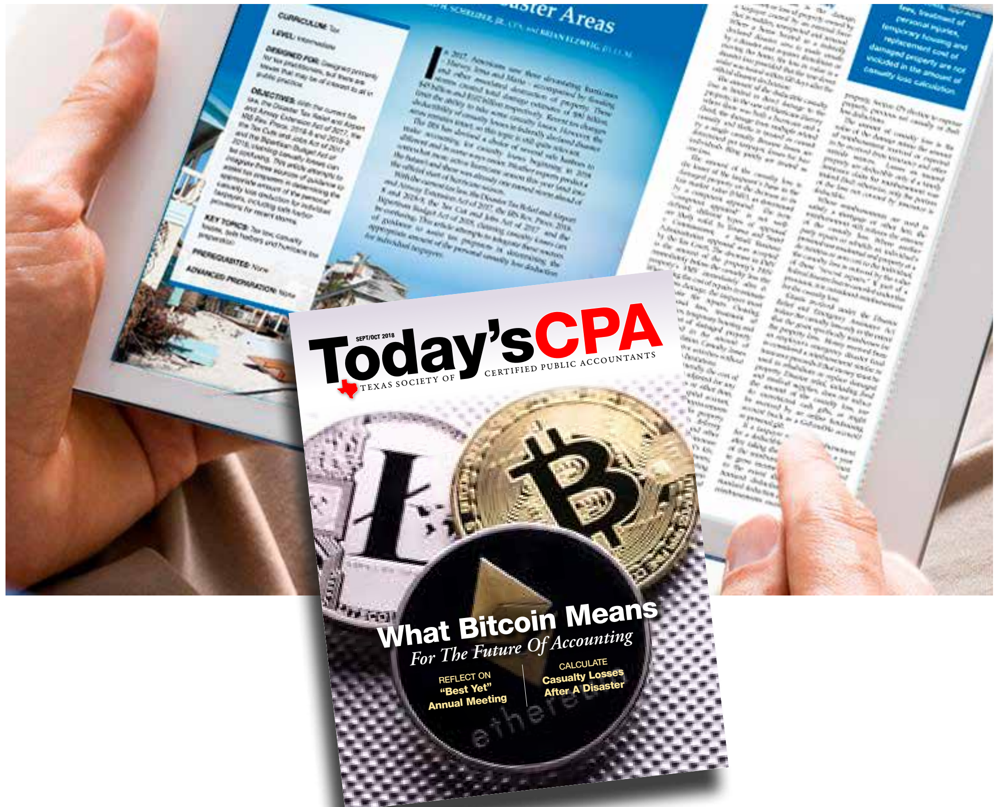
TSCPA is looking for students and faculty members to represent the Society on campuses across the state. In exchange for serving as a campus ambassador, students will receive free membership for the year, recognition in relevant TSCPA communications and more. Faculty campus ambassadors will receive a special membership dues rate of $90 (including chapter dues) for the 2018-19 year and complimentary registration to the Accounting Education Conference in October.

If you or someone you know is interested in becoming TSCPA's link to your college or university, please download the form to begin the application process. Links to the forms are available here. You can also contact TSCPA's Catherine Raffetto at craffetto@tscpa.net or 800-428-0272, ext. 216 (972-687-8516 in Dallas) for more information.

Submit an Article to *Today's CPA* Magazine

The editors of *Today's CPA* magazine are seeking articles for consideration in upcoming issues. The magazine features articles and columns that focus on issues, trends and developments affecting CPAs in various facets of business.

We are soliciting technical submissions in all areas, including taxation, regulation, auditing, financial planning, ethics and corporate governance, information technology and other specialized topics. If you would like to submit an article for consideration or to learn more, please contact Managing Editor DeLynn Deakins at ddeakins@tscpa.net or Technical Editor Brinn Serbanic at technicaleditor@tscpa.net.



Sunset Review

ROUND ONE

By JOHN SHARBAUGH, CAE

TSCPA Managing Director, Governmental Affairs

The Sunset Review process for the Texas State Board of Public Accountancy (TSBPA) and the Texas Public Accountancy Act (TPAA) recently finished round one with the Texas Sunset Commission. The Commission conducted a public hearing on August 30, where it received a report on TSBPA from the Sunset staff and heard from representatives of TSBPA and the public at large. TSCPA representatives attended the hearing to provide testimony and input to the process. Current TSCPA Chairman Stephen Parker, CPA-Houston, and I testified. The report from the Sunset staff on TSBPA contained a number of specific recommendations (21 in total), which can be viewed in their entirety here. Perhaps the most significant recommendation by the staff was to support the continuation of TSBPA for another 12 years, until the next Sunset Review process. The norm in Texas is for boards and agencies to be reviewed every 12 years. In its report, the Sunset staff noted: "Without competent accountants, pensions, local governments like school districts, and businesses on Main Street would find it harder to prevent theft and make sound investments or assure customers and creditors of their financial footing. The Texas State Board of Public Accountancy has not only pursued accountants at one of the formerly largest accounting firms in the world who failed to stop headline-grabbing fraud at Enron, but also tightened the standards and oversight of the accounting profession to make sure accountants in Texas catch bad actors and weak controls in today's complex marketplace."

> **Perhaps the most significant recommendation by the Sunset staff was to support the continuation of TSBPA for another 12 years.**

TSCPA was pleased to see this recommendation by the

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Sunset staff to continue TSBPA. We concur with the staff's assessment that the regulation of CPAs is warranted and necessary to provide adequate protection to the public.

One of the other significant recommendations from the Sunset staff, which TSCPA did not agree with, pertained to the composition of the State Board. Currently, there are 15 members of the Board, with 10 CPAs and five public members. The Sunset staff was recommending that the composition be changed to have eight public members and seven CPAs. This was an issue of major concern to TSCPA, as well as TSBPA, NASBA and AICPA. Each organization spoke against this recommendation in their formal written comments. TSCPA objected to this recommendation in its formal comment letter sent to the Commission earlier in the month. You can see the TSCPA letter here. Collectively, TSBPA, TSCPA, NASBA and AICPA all noted that a reduction in the number of CPAs serving on TSBPA would be detrimental, as it would reduce the number of qualified individuals with the necessary competence and experience to help adjudicate complaints and other matters before the Board. TSCPA noted that while having public members on the Board is also important to bring that perspective to the Board's proceedings, the general public is not really equipped to adequately assess issues of substandard practice and other technical accounting and tax issues that the Board must address.

TSCPA will be at the next scheduled Sunset Commission hearing on November 14-15, to represent our members and we'll continue to report on new developments.

The issue of moving to a "majority" public member board arose in response to a recent U.S. Supreme Court case involving a licensing board (Dental Board) in North Carolina that had exceeded its authority in pursuing and prohibiting teeth-whitening operations. The Supreme Court ruled the board in this case had committed anti-trust violations in its enforcement actions. As a result, state governments around the country are looking at ways to help mitigate these anti-trust concerns in how their licensing and regulatory boards operate. The Sunset staff recommendation to move to a majority public member board was in response to this issue.

Fortunately, the Sunset Commission decided not to adopt this particular recommendation at this time. Rather, the Commission is recommending that the Texas Legislature study this issue to determine the best solution for all boards in Texas, rather than handling the issue on a case-by-case basis. One alternative identified by the U.S. Supreme Court and guidance coming out of the Federal Trade Commission is to establish some kind of "active state supervision" mechanism for all rule proposals and proposed actions by licensing boards, to assure that anti-trust violations do not occur through board actions. We will have to wait and see if the legislature chooses this option or some other means of dealing with this concern.

Another matter TSCPA commented on was a recommendation by the Sunset staff to modify the current mandatory Peer Review program to provide a different frequency for reviews based on risk. The Staff Report was recommending that Compilations be treated differently under peer review and that if CPAs only provide Compilations or only conduct one peer review a year that they be reviewed less frequently or not at all.

TSCPA argued against this move, as did AICPA, TSBPA and NASBA in their comment letters, noting that the Peer Review program is a national program that is followed by the vast majority of states. Compilation reports are relied on by the public and there is a greater likelihood of substandard work when the service is only performed on an occasional basis. In his testimony at the hearing, TSCPA Chairman Stephen Parker pointed out that deviating from the national standards for peer review could also create mobility issues for Texas CPAs who wish to practice in other states.

TSCPA also encouraged the Commission to include some provisions to bring Texas into alignment with most other states and the Uniform Accountancy Act of AICPA and NASBA with respect to mobility and the ability of CPAs and CPA firms to practice across state lines and manage their firms. TSCPA provided these suggestions to the legislature in its formal comment letter, as well.

The Sunset Commission will now take all of the information it received at this hearing and from the public comments and develop a final report and recommendations for submission to the legislature. That final report and proposed legislation will be discussed and voted on at the next Sunset Commission hearing scheduled for November 14-15, 2018. TSCPA will be there to represent our members and we'll continue to report on new developments as this matter continues to evolve. Stay tuned for future reports.

TSCPA Conferences

Learning Opportunities in 2018

Make your plans now to attend upcoming TSCPA conferences. Come for the sessions, benefit from networking with your colleagues and leave with the knowledge you need to advance your career.

CAREER DEVELOPMENT FORUM
Professional Peers Conference for CPAs Under 40
On November 2 in Fort Worth

SINGLE AUDITS & GOVERNMENTAL ACCOUNTING CONFERENCE
Austin, October 1-2

ACCOUNTING EDUCATION CONFERENCE
Dallas, October 26-27

TEXAS CPA TAX INSTITUTE
Addison, November 15-16

San Antonio, November 15-16

CPE EXPO CONFERENCE
Dallas/Addison, November 29-30

San Antonio, December 3-4

Houston, December 10-11

TSCPA also offers thousands of webcasts and on demand programs. Use this link and search on your topic of interest to find the program you need.

For more information and to register for live and online learning opportunities, use the links above or call 800-428-0272, option 1, for personal assistance.

Texas Society of Certified Public Accountants

TSCPA Annual Meeting of Members & Board of Directors Meeting

By RHONDA LEDBETTER, TSCPA Chapter Relations Specialist

"Energizing!" "Lots of valuable information." "Best yet!" This was the buzz at the 2018 Annual Meeting of Members held at La Cantera Resort in San Antonio. We set the tone with a more casual atmosphere, which generated a palpable feeling of excitement and connectivity that lifted individuals to a higher level of engagement with each other and with TSCPA.

A new generation of the Society's volunteers was there in a two-day Leadership Development Institute. The Leadership Development Institute is a dynamic and engaging program focused on building confident, strong and effective leaders. The attendees' enthusiasm was contagious and their fresh perspectives sparked an energy surge among the other Annual Meeting participants.

Our menu of learning opportunities included a CPE seminar on the changing face of internal fraud, led by Steve Dawson, CPA-South Plains. Four 15-minute "power sessions" guided members in exploring TSCPA Exchange, tapping into social media, maximizing CPE resources and getting involved in TSCPA advocacy for the profession.

TSCPA Exchange is the virtual community where members share information and interact statewide. It's an important part of our toolkit connecting members regardless of geography or other challenges. There's a growing group of power users helping it flourish with hundreds of discussions so far.

Friday's general session opened with a conversation about the state of the Society, led by our Immediate Past Chairman Jim Oliver, CPA-San Antonio, CGMA, Chairman Stephen Parker, CPA-Houston, and President and CEO Jodi Ann Ray, CAE. They opened by outlining the vision articulated in TSCPA's strategic plan, which is to empower members to lead and succeed.

Addressing the Community and Connection pillar of success, Oliver commented, "Sometimes you have a great plan – then you get a curveball." Hurricane Harvey hit much of the Texas Gulf Coast three months into the fiscal year, affecting 9,000 members. Because we had a great plan in place, we were able to use the strategic plan's guiding principles to frame our organization's response to the disaster.

Commenting from the audience, Executive Board member Josh LeBlanc, CPA-Southeast Texas, told how his firm appreciated TSCPA's outreach to ask what help was needed. They gathered the information provided by the Society and shared it with their clients, making an impact beyond members to taxpayers and the community.

We are in a time of enormous growth in services to our 20 chapters, the places for members to connect locally. Leveraging the power of technology, TSCPA and chapter resources are being integrated to build websites and expand use of the joint database. A task force will recommend further actions enriching members' experiences at the state and local levels.

CONTINUOUS LEARNING

A culture of continuous learning is a key element of the Professional Excellence pillar in TSCPA's strategic plan. We are on top of trends, such as personalized learning, microlearning, interactive video-based learning, performance support and gamification. A learning management system focused on competency, not just compliance, is being developed to bring more content online with flexible, engaging formats for live programming.

We are providing just-in-time resources for members, such as 38 tax reform courses that were quickly developed and made available in 15 chapters. We're constantly scanning the horizon for developing issues and can turn on a dime to put together additional learning options.

Rhonda Ledbetter is TSCPA's chapter relations specialist. Contact her at rledbetter@tscpa.net.

Promoting the value of the profession to future CPAs – and those who educate them – is a key initiative. There are campus and faculty ambassadors, CPA2B boot camps, and TSCPA is nourishing relationships with accounting educators around the state. A hot spot for students of all ages is at www.txcpa2b.com.

Accounting in Extraordinary Times

AICPA Vice Chairman Bill Reeb, CPA-Austin, CGMA, opened with a fast-paced video touching on the fourth industrial revolution, reimagining the CPA profession, seismic shifts in society, regulatory complexity and new services. The message is that extraordinary times demand extraordinary leadership.

He said it's difficult to initiate change when things are going well. By 2027, 75 percent of companies in the S&P 500 might no longer be there. Legacy enterprises that are doing well have initiated their own reinvention.

The accounting profession must prepare for the future. Accounting firms can do that by nurturing their planning and tax advisory services. Market demand is soaring, while client needs are changing.

Top skills financial executives look for in auditors include technology, communications and critical thinking. AICPA is working to transform the audit process, addressing the vital need for secured data and creating a pathway that recognizes the changing skills required. Beyond the financial audit lie assurance opportunities in new areas.

Cybersecurity risk management will be an explosively growing CPA service. Board members are more aware of their fiduciary duty in this arena and are concerned about protecting their personal liability for breaches. Sustainability reporting is an emerging field, as is integrated reporting.

A survey indicates that 65 percent of members plan to acquire new skills to enhance their career in the next 12 months. The key is to learn, unlearn and then relearn. Start with an agile mindset and focus on gaining competency-based knowledge.

> **External forces driving change include geopolitical instability, technology and cyber issues, workforce changes, regulatory complexity, and financial challenges worldwide.**

Leadership in the Digital Era

Charlene Li, with Altimeter, talked about the changing face of leadership. She said that being a great leader is about relationships. Traditional hierarchies defined relationships, but now they arise from how work gets done.

In disruptive times, leaders create movements and inspire others to change. Any of us can become a leader of a movement; the key is to inspire followers. Leaders must be visible and easy to follow. They do this by extending themselves into the digital space and can use technology – like TSCPA Exchange or social media channels – to deepen business relationships.

Our important audience is online. We can't afford to pass up a digital link with those important to our success: coworkers at all levels, colleagues in our field and others.

Li challenged the group to look at the beliefs that are keeping us from a digital presence and ask ourselves what new beliefs we must adopt to succeed, moving from our comfort zone to the place where the magic happens.

Your "And"

John Garrett, "The Recovering CPA," is on a mission to help CPAs prevent professionalism from suffocating their personality. Your "and" is the part of you outside of work – your hobbies, activities, the things that complete your whole self. They give you a sense of identity and make you memorable. The more "ands" you have, the less likely you'll be prone to work-related anxiety or even depression.

Sometimes being the best professional isn't about your technical skills. It's good to a point, but the teeter-totter can tip and your work life get out of balance.

TSCPA'S FIVE AREAS OF FOCUS

Successfully Navigate Sunset Review
Continuation of an independent board governing CPAs keeps the focus on the high standards necessary to protect the public.

Engage and Grow Our Community
We need to continuously evolve to welcome the next generation of CPAs. We'll increase the strength in our numbers and boost members' engagement.

Fuel Our Chapters
Our strong chapter network sets us apart and allows us to provide uniquely local connections. We are focused on providing resources to fuel our chapters to provide additional value to our members.

Reenergize Our Brand
We must have a clear message and presence as we demonstrate our value proposition to our current and future members.

Advance the Future of Learning
We're all about helping CPAs be the best they can be and adapt to a changing environment. The learning landscape has changed dramatically and we will lead the way.

As you're letting people get to know what you bring in addition to professionalism, you can start to show a genuine interest in others. Start by conversing about work and then ease into asking about their hobbies. Do you know what 91 percent of your coworkers do for fun?

It's never too late to start. If you're in management:

- encourage others to open up by having photos in your workspace that show your hobby;
- when you're giving an employee a gift card, connect it to what they like – not just a generic one to a coffee chain, but maybe to a pet store, golf course, etc;
- have company events to create easy shared experiences where people can be comfortable opening up; and
- include a spotlight in the company newsletter or updates on employees' activities.

The tone at the top matters.

CPE Foundation

The annual meeting of the CPE Foundation was held. Ryan Bartholomee, CPA-Permian Basin, CGMA, reported that online program revenue was up almost 50 percent and Summer Cluster attendance was very strong, while seminars and conferences have declined. At the CPE Strategic Planning meeting, it was recommended that the focus be on customer service, proximity and a holistic approach.

There will be continued investment in developing chapter relationships to support differentiation. The Foundation has partnered with several chapters to co-host programs and will look for more opportunities to do so.

A host of initiatives is planned, including:

- enhance the learning experience by incorporating more engagement into programs;
- continue to explore different pricing strategies to be more competitive in the marketplace;
- work with TSCPA's Business Development team to broaden our sponsorship reach; and
- develop and curate content for TSCPA online programming.

PROFESSIONALISM
And Your Personality

What if professionalism:
Stifles your career?
Turns you into a stock image on a business website?
Makes you a stereotype?

Don't let that happen to you.

Accounting Education Foundation

The President of the Accounting Education Foundation Board of Trustees, Fred Timmons, CPA-San Antonio, CGMA, provided an update on the work of the Foundation. Some of the projects include:

- underwriting the Accounting Education Conference, an event where educators network and obtain relevant continuing professional education;
- making a contribution to the AICPA Minority Scholarships, which were given to seven students in Texas; and
- awarding $2,500 scholarships to 50 qualified accounting students at Texas universities.

2018 LEADERSHIP DEVELOPMENT INSTITUTE PARTICIPANTS

Omolara Akinboye
Michelle Barton
Cristina Baumgardner
Kelly Boswell
Kathryn Devey
Kay Dixon
Kelly Fisher
Kimberly Green
Harrison Haake
Andrew Hughes
Rosalinda Marikar
Nancy Meza
Shawnee Miller
Bryan Morgan
Whitney Murley
Lisa Pitts
Pamela Rodriguez
Lauren Seaux
Stephanie Shaner
Samuel Teichelman

CHAPTER CHALLENGE GOLF TOURNAMENT

The golfers were:

Austin Chapter
Jesse Dominguez
Jeremy Myers
Joyce Smith
Rick Smith
Steve Wesling

Central Texas Chapter
Alton and Twila Thiele

East Texas Chapter
Ron Cook
Randall Noe
Keith Pfeffer
Royce Read

Houston Chapter
Billy Atkinson
Mark Lee

San Antonio Chapter
Chuck Clark
Fred Timmons

Southeast Texas Chapter
Josh LeBlanc

TSCPA
John and Carolyn Sharbaugh

To help fund its work, the Foundation held a silent auction during the Annual Meeting. The net raised was almost $13,000, significantly more than the previous event. There are several ways to donate throughout the year, including purchases through Amazon Smile.

Charlotte Jungen, CPA-Houston, and Ed Polansky, CPA-San Antonio, were recognized as Kenneth Hurst Fellows for being outstanding supporters of the Foundation.

Peer Assistance Foundation

Steve Mize, CPA-Fort Worth, CGMA, conducted the annual meeting of the Peer Assistance Foundation. He shared the purposes of the Accountants Confidential Assistance Network (ACAN), which are to:

- inform students and professionals about common performance-impairing problems, such as alcoholism and mental health issues;
- motivate affected persons to seek help;
- support affected persons in their recovery;
- encourage recovering accountants to share their experience.

As the Peer Assistance Foundation moves toward celebrating its 25th anniversary, it has a vision to be a champion of wellness resources for all current and future CPAs.

CPA-PAC

Jesse Dominguez, CPA-Austin, chair of TSCPA's CPA-PAC, showed where accountants ranked in contributions to the 2016 elections compared to other groups in Texas – and encouraged more members to participate. He also asked for members to serve as key persons to legislators.

Business Matters

The 2017-2018 financial report was presented. Our 2018-2019 Treasurer Ben Simiskey, CPA-Houston, presented the new fiscal year budgets, which were approved.

During the annual meeting of the Accountancy Museum of the Texas Society of CPAs, Inc., directors were elected.

Plan Now for Future Gatherings

The Midyear Board of Directors and Members Meeting will be held in Austin Jan. 29-30. Watch the weekly *Viewpoint* e-newsletter for information.

New Orleans is the site for the 2019 Annual Meeting of Members and Board of Directors Meeting, June 21-22. We'll reach out to our Louisiana neighbors to make new connections and strengthen friendships. *Laissez bon temps rouler!*

Visit www.tscpa.org for:
2018-2019 Executive Board
2017-18 Award Recipients
Awards Criteria

Please also see the Chapters column in this issue for highlights from the Outstanding Chapter Awards.

CRYPTOCURRENCIES:
Implications For The Future of Accounting

By **MICHAEL WILSON**, CPA, and **BARBARA A. BELTRAND**, CPA

Cryptocurrencies, the most well-known of which is Bitcoin, present overt and major challenges to the accounting profession. Major issues for financial accounting purposes include measurement, recognition, presentation and disclosure. For auditing and other attestation services, the major issues include risk assessment, assessment of identified risks, internal controls (including IT controls) and selection of appropriate audit methodologies. Tax issues involve appropriate classification of digital currencies for tax purposes, as well as taxability of digital transactions. There are also a host of other issues that remain as yet unaddressed. There is little or no extant guidance for use by controllers, chief financial officers, internal auditors, tax accountants and external auditors.

Before we dive into the audit and accounting issues, let's consider some background information on cryptocurrencies and the underlying technology.

The Chamber of Digital Commerce (The Chamber) is a leading trade association of the blockchain industry. The Chamber is self-proclaimed to be the world's largest trade association representing the blockchain industry, whose mission is to promote the acceptance and use of digital assets and blockchain-based technologies. Membership is comprised of over 100 companies innovating with, and investing in, blockchain-based technologies, including financial institutions, exchanges, software companies, top consultancies and cutting edge fintech start-ups.

According to the Chamber: "Digital currency transactions rely on underlying technology called blockchain technology. Blockchain technology uses a peer-to-peer decentralized and distributed network that allows parties that do not know each other to transact securely without the use of an intermediary. Transactions are recorded on a public digital ledger which is shared with all other computers connected to the network. Each computer, or 'node,' on the network maintains a full copy of the historical ledger and participates in the maintenance of an accurate and secure ledger."

The Chamber continued: "Transactions are encrypted and cannot be changed or deleted after a 'mining' node has posted a 'block' of transactions to the network and the rest of the network has validated the block of transactions. The first blockchain application was the digital currency called bitcoin. What makes the bitcoin digital currency so unique is that it is based entirely on mathematics. In other words, consumers no longer need to rely on a financial institution to settle transactions; the settlement process is integrated into the software network, via complex math verification features, making sending money instant, globally accessible and extremely cost-effective."

When we talk about digital currencies, such as bitcoin, it is important to make a distinction between bitcoin the currency and the blockchain. Bitcoin is like a railroad car and blockchain is like the rails it rides on. Blockchain is a digital ledger of economic transactions that are transparent and continuously updated by countless global users.

Blockchain is considered difficult to corrupt because a hacker would need to overpower private exchanges across the internet; i.e., "distributed ledger technology" (Thomason) that interact and update the ledger. "In theory it cannot be hacked because that would require overpowering all the computers that contribute to and update the ledger network – a feat akin to hijacking the entire internet" (Carlozo).

Cryptocurrencies, like bitcoin, are virtual currencies that use cryptography for security. A digital currency is a digital asset and represents a method of exchange that does not physically exist, but rather exists digitally. The most widely used digital currency is bitcoin, but it is not the only digital currency (Chamber).

According to the Chamber, new products and services derived from blockchain technology may lead to a paradigm shift in many industries – including banking, government records, title and asset ownership, digitization and encryption of medical records, digital identity, trading, clearing and settlement, secure voting systems, and many others. Blockchain technology is a newly created medium – an operating system for money (or anything of value, for that matter) and allows for digital currencies to be programmable.

While there are numerous exchanges and they operate in different ways, all cryptocurrencies share common characteristics. According to Reuters, individuals or entities wishing to transact in cryptocurrencies must create an account and deposit some type of currency or cryptocurrency into it. The entity then initiates transactions from this account and records those transactions on the blockchain digital ledger – either in a "hot" (online) wallet or a "cold" (offline) wallet. The online or hot wallet is more vulnerable to hacking than the cold wallet. The virtual exchange charges for each trade, typically as a percentage of the transaction. Finally, because there are multiple exchanges with varying prices, arbitrage opportunities exist.

The newness (less than 10 years) of cryptocurrencies and their "inherently pseudo-anonymous" nature has led to a high level of skepticism on the part of the Internal Revenue Service (IRS) and other regulators, as well as predictions

FIGURE 1.
Cryptocurrencies With Largest Market Capitalization Values

Name	Market Cap	Price	Volume (24h)	Change (24H)
BITCOIN	$181,789,618,320	$10,775.40	$8,210,340,000	6.93%
eTHEREUM	94,189,661,210	964.29	2,436,410,000	2.65%
RIPPLE	46,385,468,461	1.19	1,118,200,000	5.08%
BITCOIN CASH	25,966,803,846	1,529.89	665,698,000	1.84%
Litecoin	12,594,821,806	227.91	867,588,000	(.39)%
cardano	10,797,172,963	0.42	334,686,000	3.21%
NEO	8,777,665,000	135.04	280,898,000	5.49%
STELLAR	8,678,516,207	0.47	102,622,000	3.90%
IOTA	6,027,022,284	2.17	39,169,400	4.00%
dash	5,769,357,563	731.20	113,254,000	5.75%

Note: Market capitalization is calculated by multiplying price by the circulating supply. Price is calculated by taking the volume weighted average of all prices reported at each market. Circulating supply is an approximation of coins circulating in the market and in the general public.

Source: CoinMarketCap's webpage Cryptocurrency Market Capitalizations of dramatic transformations in multiple industries (IRS News). "No one was talking about it before 2008," said Boomer, the chief strategist for Boomer Consulting. "Then in 2013 we started to see the rise of bitcoin, a blockchain consortium in 2015 and proof of concept in 2016."

Boomer expects that blockchain may begin to replace legacy accounting systems around 2023, "and by 2025, it will be widely accepted" (Carlozo). The cryptocurrencies with the largest market capitalization values as defined by multiplying price by the circulating supply as of Feb. 8, 2018 are shown in Figure 1.

CoinMarketCap is one of several "price checking" sites for cryptocurrency. According to Sedgwick, there are viable, and perhaps more robust, entities that provide data that reflect on market capitalization and the valuation of the various cryptocurrencies, including:

- Onchainfx
- Coincodex
- Cryptocompare
- Bitinforcharts
- Coincheckup
- Coingecko
- Coincap
- Coinlib

Accounting Issues

To emphasize how early cryptocurrencies are in terms of stage of development, the Financial Accounting Standards Board (FASB) has not yet taken a position on just what type of asset cryptocurrencies are. For example, the Chamber requested, in a letter dated June 8, 2017, that FASB create guidance on the measurement, recognition, presentation and disclosure for digital currencies and related transactions. "We request that the Financial Accounting Standards Board add to the Board's or Emerging Issues Task Force's (EITF) agenda a project to address the accounting for

THE IRS PLANS TO ISSUE WARNINGS ABOUT THE TAXABLE NATURE OF CRYPTO TRANSACTIONS

digital currencies."

More than six months later, FASB Chairman Andy McMaster reported to the Financial Accounting Standards Advisory Council (FASAC) on Dec. 14, 2017, that the staff has performed research on digital currency. (FASAC) The research and due diligence process promises a protracted timeline for the development of authoritative accounting guidance.

Meanwhile, businesses must account for both the use of digital currencies when used as consideration in exchange transactions and account for valuation of such currencies when held at the financial reporting date. With no authoritative literature under U.S. GAAP for digital assets, including digital currencies, the recognition, measurement, presentation and disclosure of digital currencies by companies cause management and the company's auditors to face a deep conundrum.

Armed with no specific guidance for measurement and disclosure of such currencies, accounting professionals mostly find that they must return to the non-authoritative Concepts Statements, as well as the FASB

Accounting Standards Codification to attempt to make reasonable analogies. In their letter to FASB requesting accounting guidance, the Chamber of Digital Commerce suggests there are four Codification topics that may be appropriate; however, the Chamber ultimately concludes that a new sub-topic is the more probable path to relevant accounting guidance.

The Chamber identified the following Accounting Standards Codification (ASC) topics as potentially appropriate for accounting for digital currencies:

- ASC 305, *Cash and Cash Equivalents*;
- ASC 330, *Inventory;*
- ASC 350, *Intangibles;*
- ASC 825, *Financial Instruments.*

Based on the FASB Conceptual Framework, it is relatively easy to conclude that digital currencies are an asset based on the concept of assets as probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events (FASB Concept 6). However, none of the potential topics listed above satisfactorily address relevance and faithful representation – the fundamental qualitative characteristics of U.S. GAAP's conceptual framework.

Consequently, the Chamber suggested that a new subtopic could create a "model under which an organization would recognize the digital currency when it controls the associated economic benefits and measures the digital currency each period at fair value with changes in fair value recognized in income."

FASB operates in a particular political and cultural environment – including, but not limited to, SEC regulations. The results of the FASB research and subsequent deliberations is eagerly anticipated by practitioners who must prepare the financial statements and the marketplace analysts as they prepare to buy/sell stock. Pricewaterhouse Coopers (PwC), for example, applauds FASB for "… researching this topic in consideration of potential standard-setting and encourages them to undertake a project to consider the accounting for cryptocurrencies" ("Point of View: Cryptocurrencies").

Tax Considerations

The IRS mandates that digital currencies be treated as property. For example, prior to the use of a digital currency to effect an economic transaction (like purchasing inventory), the company must recognize that, in substance, the company has an investment property and has sold it. This sale of property prompts recognition of either a gain or loss as of the date of the receipt/payment. IRS Notice 2014-21 indicates that the sale transaction is measured at the fair value of the virtual currency in U.S. dollars and must be reported on the entity's federal tax return.

The IRS plans to issue warnings about the taxable nature of crypto transactions, because the anonymous nature of transactions effected in a digital currency may tempt taxpayers to avoid recognizing the transaction on their tax returns. Failure to report transactions in digital currencies and the associated gains (losses) in earnings can subject a taxpayer to penalties and interest and may extend to criminal prosecution. (IRS News Release IR-2018-71).

The IRS plans to issue warnings about the taxable nature of crypto transactions. However, according to Thomason, thorny issues remain. Examples include whether section 1031, allowing for deferral of gains and losses from token exchanges, applies to digital currency transactions. In addition, hard forks cause a blockchain to split into more than one version. According to Investopedia, a hard fork is:

[A] permanent divergence from the previous version of the blockchain and nodes running previous versions will no longer be accepted by the newest version. This essentially creates a fork in the blockchain: one path follows the new, upgraded blockchain and the other path continues along the old path. Generally, after a short period of time, those on the old chain will realize that their version of the blockchain is outdated or irrelevant and quickly upgrade to the latest version.

Lapat indicates that tax preparers looking for guidance should consider taking aggressive positions in this period of uncertainty.

SEC Considerations

The Securities and Exchange Commission (SEC) has defined virtual currencies as a "digital representation of value that can be digitally traded and functions as a medium of exchange, unit of account or store of value" (SEC Investor Alert). However, no initial coin offerings (ICOs) have been registered with the SEC. The agency has yet to approve for listing and trading any exchange-traded products (such as ETFs) holding cryptocurrencies or other assets related to cryptocurrencies, according to a public statement made by SEC Chairman Jay Clayton, on Dec. 11, 2017.

The SEC warns that "cryptocurrency markets span national borders and may include significant trading on systems outside the United States. Invested funds may quickly travel overseas without the investor's knowledge. As a result, risks can be amplified, including the risk that market regulators, such as the SEC, may not be able to enforce United States laws in dealing with transactions denominated in a cryptocurrency" (Clayton).

Due to these considerations, the SEC (Clayton) recommends the following questions be considered when considering a cryptocurrency or ICO investment opportunity:

- Who exactly am I contracting with?
- Who is issuing and sponsoring the product, what are their backgrounds and have they provided a full and complete description of the product? Do they have a clear written business plan that I understand?
- Who is promoting or marketing the product, what are their backgrounds and are they licensed to sell the product? Have they been paid to promote the product?
- Where is the enterprise located?
- Where is my money going and what will it be used for? Is my money going to be used to "cash out" others?
- What specific rights come with my investment?
- Are there financial statements? If so, are they audited and by whom?
- Is there trading data? If so, is there some way to verify it?
- How, when and at what cost can I sell my investment? For example, do I have a right to give the token or coin back to the company or to receive a refund? Can I resell the coin or token and if so, are there any limitations on my ability to resell?

THE SIZE, SCOPE AND COMPLEXITY OF AUDITS CHANGE WHEN AN ENTITY HOLDS AND TRANSACTS BUSINESS USING A CRYPTOCURRENCY.

- If a digital wallet is involved, what happens if I lose the key? Will I still have access to my investment?
- If a blockchain is used, is the blockchain open and public? Has the code been published and has there been an independent cybersecurity audit?
- Has the offering been structured to comply with the securities laws and, if not, what implications will that have for the stability of the enterprise and the value of my investment?
- What legal protections may or may not be available in the event of fraud, a hack, malware or a downturn in business prospects? Who will be responsible for refunding my investment if something goes wrong?
- If I do have legal rights, can I effectively enforce them and will there be adequate funds to compensate me if my rights are violated?

Those who decide to transact business or invest in digital currencies are stringently warned by the SEC as to the risks that such transactions bring and the responsibilities of "Main Street" investors and market professionals (broker-dealers, etc.) to deal with those risks in a prudent and consistent manner.

Auditing and Attestation Issues

When an entity holds any form of a cryptocurrency, accountants who prepare financial statements and CPAs who perform attestation services face unique challenges in addressing the informational needs of investors and other stakeholders. The size, scope and complexity of audits change when an entity holds and transacts business using a cryptocurrency. The risk assessment process during planning and throughout the remainder of the audit should consider relevant management assertions, including existence/occurrence, valuation, rights and obligations, and completeness.

Auditors must develop appropriate audit strategies, which may include the prospect of reducing the auditor's role in verifying blockchain transactions because of the inherent security of the digital ledger maintained by a network of users. However, regulations for the industry have not yet been addressed at high levels. This suggests that some regulatory actions by the SEC and other regulators may be forthcoming.

The primary risk assessment should focus on information technology (IT) risks. The best control environments have IT systems that maintain private security keys and access to such keys is restricted to a limited number of individuals who have been properly vetted as to qualifications and necessity. According to Nabors, a senior IT analyst at Weaver, a nationally oriented accounting firm's general IT controls should include:

1. Backups – A backup should be maintained of the private key. The backup should be restricted and protected the same as any connect device.
2. Anti-virus/anti-malware – The machine that contains the private key is free of malware that could expose the private key.
3. Vulnerability monitoring – The infrastructure and network should be monitored for vulnerabilities and remediated when identified.
4. Restricted access – Access to information should be restricted to only those who need to know.
5. Encryption – Data at rest and in-transit should be encrypted.
6. Assess and monitor the service provider – Identify and use a trusted wallet software,

specifically one that is used in deterministic mode. This allows for protection of a master private key, child private keys and public keys that can be shared (Nabors, "Risk Considerations").

Specific audit considerations include the type of audit program that may need to be modified to address the risk of misstatement in an entity's financial reporting. If a cryptocurrency is considered an intangible asset that is measured at fair value (remember, we have not made this specification as a profession yet), specific audit questions may include the following audit activities as outlined in standard audit programs for intangible assets like Thomsen Reuters proprietary audit programs available through Checkpoint ™. Intangible asset audit programs often include the following steps.

1. Inquire whether cryptocurrencies have been tested for impairment and review the results of the impairment tests.
2. Ensure that workpapers include the information needed to support required financial statement disclosures related to fair value measures and the information has been subjected to audit procedures.
3. Consider the need to apply additional procedures and whether the results of audit procedures indicate internal control matters, specifically in the area of IT controls that are required to be communicated to management and others.
4. Determine whether insurable risks have been considered.
5. Compare values to independent sources of valuation and consider if values can be confirmed.
6. Consider whether any loans exist with cryptocurrency serving as collateral and whether loans can be confirmed.
7. Consider whether asset protection is in place and operating effectively. This may include verifying whether transactions are protected with the necessary security and encryptions that are in place and up to date. An audit firm will likely need to create not only diverse audit teams with professionals other than CPAs, but also update the firm's quality control policy and procedures to require that each member of the audit team is trained in cyber and software auditing.
8. Document the integrity of the audited entity's IT systems, applications and controls through risk assessment of the clients and relevant third parties, such as brokers, or the exchanges themselves.

The external auditor's most valuable role often lies in the advice provided to mitigate risks. Hacking and theft have caused conservative investors to avoid the asset class. Thomason at the Richey May accounting firm recommends that "clients consider holding a certain percentage of fund net asset value in fiat currency in commercial bank accounts that provide FDIC insurance and thereby add another layer of protection due to the bank's controls."

Thomason also advises auditors to be aware of steps taken by digital currency exchanges to reduce the risk for investors. For example, some exchanges perform proof of reserves testing. These tests are designed to prove that the currency in exchanges: "matches the amount required to cover an anonymized set of customer balances. With these audits, exchanges hope to provide transparency as a means to reassure investors of the security of their digital assets. Stakeholders should also recognize the reduced risk associated in offline wallets, known as cold storage, where the assets are held through a qualified custodian. Other considerations (although expensive) include insurance on digital assets."

Recently, a group of the world's 20 largest economies, including China, the United States and Japan, convened to discuss the regulation of cryptocurrencies, among other topics. The central message was the commitment to regulate, but not ban the market.

We anticipate the rails of blockchain will continue to serve as a source of innovation perhaps with financial institutions finding ways to adopt the technology, but the cars – Bitcoins and others – may face turbulent times as new designs are developing. For risk adverse investors, this seems like a good time to ensure their exposure to the asset is limited.

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Selling for the Greater Good

Why business owners should consider and discuss with their CPA the potential benefits of donating company ownership before a sale, not after.

By MARK W. HAGAN, CFP®, CAP®, UBS Financial Services, Inc.

Often when an entrepreneur considers selling his/her business, there is an initial thought of wanting to do good for others with some portion of the proceeds. Because of the emotional nature of focusing on the transaction to maximize value for shareholders and family, opportunities can be missed. Despite their best intentions, charitably minded entrepreneurs frequently fail to maximize the amount of money going to their favorite charity/charities while potentially reducing the amount of money that would go to the federal government. A CPA can often times be the most trusted advisor for entrepreneurs; therefore, you have a unique opportunity to discuss the benefits and the challenges.

While there may be uncertainties that entrepreneurs have to address when selling their business, the uncertainty of having enough income in retirement is usually a priority. The thought of giving money away before a sale is not usually a topic that is of interest. As a CPA, this can help differentiate you and your practice by sharing the specifics of a charitable remainder trust (CRT).

A CRT is "a tax-exempt irrevocable trust designed to help reduce the taxable income of individuals by first dispersing the income to the beneficiaries of the trust for a specific period of time and then donating the remainder of the trust to the designated charity or charities."[1]

Donating stock prior to a sale can have several benefits. From a tax perspective, it can potentially reduce the value of your client's estate and it can reduce the amount of capital gain taxed owed. From a retirement perspective, it can help provide income to your client and their loved ones. From a philanthropic perspective, it can potentially maximize the money your client can give to the causes they love, as well as provide some level of certainty to the receiving charities that their programming goals will be funded.

Why Do So Many Business Owners Donate to Their Favorite Charities After a Sale Rather Than Before?

Oftentimes people who give to charity have more than one that they care about helping. They have a spirit of wanting to help them all and trying to decide which charities to give to, how much to give and how often can complicate the decision process. Not truly knowing how much income will actually be needed in retirement can be another issue. These factors all usually intersect at a point of no action until after a transaction has occurred.

There are three basic questions that a CPA can help clarify for clients, in an uncomplicated way, if it is better for them to give shares to a charity or charitable entity prior to a sale or after:

1. What causes are important to you currently?
2. Have you thought about making a direct gift to the charities you love?
3. Would you like to have an income stream generated by the assets that would be donated to charity?

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What causes are important to you currently?

Since people who are charitably inclined have a heart for more than one organization, it can be difficult to decide who to donate to. This feeling of being rushed to make a decision before a sale occurs makes it easy to wait to do something about it until after the transaction is completed. As a CPA, you can help lessen this feeling of being rushed by discussing some of the benefits of transferring ownership to a donor advised fund prior to the sale to the entity.

Have you thought about making direct gifts to the charities you love?

You often hear of entrepreneurs gifting some part of their company stock to a charity directly, but this could potentially create certain tax traps that were unintended for the charity. You have the ability to speak directly to these potential tax traps, unlike a wealth manager or some attorneys.

One tax trap that can be created is unrelated business taxable income (UBTI). This can occur when gifting an active business asset. Establishing a donor advised fund can potentially remove this issue.

Would you like to have an income stream generated by the assets that would be donated to charity?

Whether this applies to income for your client or for some other family members of the client, if this answer is yes, a CRT might be a good option for you to consider for your client.

Donation of business shares to a CRT can potentially provide an income tax deduction. Depending on the type of charity that will ultimately receive the donation, the deduction allowable will be based on either the fair market value of the donated shares or the cost basis. As a CPA, you should always confirm the potential tax treatment prior to selecting the charity or charities that will benefit from the remainder interest.

Once the client or any other non-charity beneficiary (this can be their children) begins receiving income, the income received would be subject to income tax in the year it was received.

There are a few different choices as to how long the income stream can last. If the client (grantor) is the beneficiary, they can choose it to last over their expected lifetime. If they are married, they can choose it to last until the second death. If they are providing income to a beneficiary other than themselves, they can choose a period of time not to exceed 20 years, with the remainder passing to charity[2]. Any one of these options could provide some comfort to your client that they are not giving away assets that are needed to generate income during the early years of retirement.

For the charitably minded entrepreneur, pre-transaction planning creates an opportunity to help the causes they love without jeopardizing their liquidity or cash flow needs in retirement. This, however, is not always immediately clear prior to the sale of a business. As a CPA, you are potentially one of your clients' most trusted advisors and they will likely look to you for sound strategies to help

Figure 1. The Impact of Donating a 20% Non-voting Interest in a 5MM C-Corp (Cost Basis 100K)

	Income tax liability of business owner	Value to charity	Income tax saved by business owner	Total tax benefit for owner
Scenario 1 Sell then donate	1,166,200 (2a)	766,760 (3a)	283,701 (4a)	283,701 (5a)
Scenario 2 Donate then sell	932,960 (6a)	370,000 (7a)	370,000 (8a)	603,240 (9a)

2a. Sale of the business triggers long-term capital gain tax and Net Investment Income Tax (NIIT) of $1,166,200. Calculation: tax bracket of 23.8% (20% federal + 3.8% NIIT) X 4.9MM ($5MM minus 100K basis) = $1,166,200.

3a. Only $766,760 goes to charity since you are giving from after-tax proceeds (5MM - $980,000 capital gains - $186,200 NIIT = $3,833,800 X 20% gifted portion) = $766,760.

4a. Assumes 37% tax (37% federal) X $766,760 deduction = $283,701.

5a. Total tax benefit = income taxes saved.

6a. Assumes the asset is owned by the non-profit at time of sale. No NIIT or long-term capital gain tax on donated portion. Calculation: 5MM asset - 1MM gift - 80K cost basis = personal gain of $3,920,000 X 23.8% (20% federal + 3.8% NIIT) = $932,960

7a. Assumes full 1MM is received by the charity since charity does not pay capital gains tax and is not subject to NIIT on the gift.

8a. Assumes 37% effective tax (37% federal) X 1MM deduction = $370,000 (assumes full deduction can be taken against ordinary income)

9a. Assumes $233,240 in long-term capital gain tax and NIIT are saved plus $370,000 income taxes saved = $603,240 total tax benefit for the owner.

them understand the key issues they might face.

You have the unique ability to help maximize the positive impact entrepreneurs can have for the causes they love and their family by explaining the potential tax benefits of a CRT and helping your clients understand their specific cash flow needs in retirement.

By demonstrating a meaningful solution, you can help reduce the emotional stress when making a decision. Don't let the stress of the transaction keep you from asking your clients the three simple questions. The causes they support are counting on it!

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FEATURE ARTICLE

This article is the fourth in a series of articles examining major changes from the **Tax Cuts and Jobs Act** of 2017 and looks to the provisions addressing the deductibility of business interest expense.

Interest-ING Changes Further Restrict Deduction of Debt Financing Costs

By **TIM THOMASSON** and **DON CARPENTER**

The optimal mix of debt and equity in a business's capital structure is one of the most critical financial decisions made by management. The tax deductibility of interest expense versus the non-deductibility of dividends has long been a significant advantage of debt.

Well-publicized business provisions of the new tax law included the reduction in the corporate tax rate to 21 percent, a partial move towards a territorial system for international operations and the implementation of a partial deduction for business income from certain flow-through entities. Congress needed revenue offsets to lower the potential negative impact on the deficit that these three provisions are projected to have. One mechanism Congress is using to provide offsets is new limitations on the deduction available for business interest expense. In contrast to prior interest expense limitations that focused almost exclusively on related party debt, Congress is making no distinction between debt amongst affiliated parties and third-party debt.

A Brief History

Concrete limitations on the deduction of various types of non-business interest expense have existed in the Internal Revenue Code (IRC) for many years. For example, Congress has provided very objective and mechanical limitations for deducting interest on mortgages, which have been modified somewhat in the new act. The IRC also limits the deduction for interest paid on student loans to taxpayers under certain income thresholds. Likewise, interest expense on loans used to buy investment assets by individuals has been limited to the investment income derived from those assets. And interest expense on personal debt and on loans to finance tax-exempt income is disallowed entirely.

But limitations on the deductibility of interest expense on business loans has been far more subjective. Congress originally attempted to address this issue with IRC Section 385, in which the Internal Revenue Service (IRS) was given legislative authority to issue regulations classifying certain shareholder-corporation relationships as equity rather than debt. Initial regulations issued under IRC Section 385 were largely ineffective and much of the analysis as to whether an instrument should be classified as debt or equity was based on a variety of factors in case law.

In 2016, the IRS issued revised regulations under IRC Section 385. These regulations were narrower in scope and attempted to curtail inappropriate erosion of the U.S tax base by foreign shareholders of U.S. corporations. Congress did provide more concrete restrictions on the deductibility of interest expense to related parties through two additional provisions. First, IRC Section 267 requires that interest expense to a related party is only deductible when actually paid, even for an accrual method obligor. Second, IRC Section 163(j), prior to the modifications we are discussing in this article, limited the deduction of interest expense owed to foreign related parties to a percentage of the taxpayer's cash flow.

All of these provisions focused primarily on debt between related parties, with a particular focus on foreign lenders and in the case of IRC Section 385, introduced a level of subjectivity that made enforcement very difficult. In the new act, Congress amended IRC Section 163(j) to provide a broader, more mechanical limitation on the deduction of business interest expense.

What Changed

Before delving deeper into the specific aspects of the new limitations on the deductibility of business interest expense, let's examine an overview of the new framework of IRC Section 163(j):

- For tax years beginning after December 31, 2017, the deduction for business interest expense will be limited to the sum of (1) business interest income and (2) 30 percent of adjusted taxable income (ATI). A special provision excludes floor plan financing interest from this limitation.
- Business interest expense is any interest paid or accrued on indebtedness allocable to a trade or business activity regardless of the type of legal entity conducting the trade or business. The new law specifically excludes investment interest expense from this definition.
- For tax years beginning before January 1, 2022, ATI is determined by reducing taxable income by business interest income and increasing it by business interest expense, any net operating loss (NOL) deduction, the new pass-through deduction and cost recovery items (depreciation, depletion and amortization).
- For tax years beginning on or after January 1, 2022, the cost recovery items are not added back in determining ATI.
- A taxpayer can carry forward any disallowed interest expense indefinitely. Such carryforward is treated as additional business interest expense in subsequent taxable years.
- The limitation is calculated at the business entity level, including partnerships and S corporations. Complex rules exist for the interaction of the interest limitation at the pass-through entity and owner levels and the impact of any disallowed interest on the owner's tax basis in the entity.
- This limitation does not apply to taxpayers with average annual gross receipts in the three previous tax years of $25 million or less. In addition, farming and real property businesses that elect to depreciate assets using the Alternative Depreciation System (ADS) are also exempt, as are certain regulated public utilities.
- Unlike the old IRC Section 163(j) limitation, there is no debt to equity safe harbor and any excess limitation capacity does not carry forward to subsequent years, nor can disallowed business interest expense be carried back.

With this overview in mind, we will examine the individual components of the new limitation.

The Basic Calculation

Calculating the Limitation

Under newly revised IRC Section 163(j), the limitation for deductible business interest expense is the sum of (1) business interest income and (2) 30 percent of ATI. In no event can ATI be less than zero. To better understand these two components, let's consider the following example.

Debtor Inc., a calendar year corporation that is not eligible for any exclusion from the new interest expense limitation, has $20 million of taxable income in 2018, before deducting business interest expense of $1 million. Taxable income includes the following items related to this limitation: (1) business interest income of $3 million, (2) tax depreciation of $15 million and (3) a NOL carryover from 2017 of $5 million.

Since Debtor Inc.'s business interest income exceeds its business interest expense, there is no disallowed interest expense in 2018. Debtor can deduct all of its business interest expense of $1 million.

However, assume that business interest expense is $10 million instead of $1 million. All of the other facts remain the same. In this case, Debtor Inc.'s business interest expense exceeds business interest income, so a calculation of ATI is necessary:

Taxable Income before interest expense	$20,000,000
Add: Depreciation	15,000,000
Add: NOL carryover	5,000,000
Less: Business interest income	(3,000,000)
Adjusted Taxable Income (ATI)	$37,000,000
30% of ATI	$11,100,000

In this example, Debtor once again can deduct all of its business interest expense. The limitation is the sum of (1) $3 million of business interest income and (2) $11.1 million, representing 30 percent of ATI. Thus, Debtor Inc. has the ability to deduct up to $14.1 million of business interest expense, which exceeds its business interest expense of $10 million by $4.1 million. Unlike the old IRC Section 163(j) rules, there is no carryforward of this excess limitation, nor can Debtor Inc. carry back to 2018 any future disallowed business interest expense.

If in the previous example, Debtor had a taxable loss of ($4 million) before deducting business interest expense of $10 million, the company's ATI would be:

Taxable income before interest expense	($4,000,000)
Add: Depreciation	15,000,000
Add: NOL carryover	-0-
Less: Business Interest Income	(3,000,000)
Adjusted Taxable Income	$8,000,000
30% of ATI	$2,400,000

In this example, Debtor Inc. can deduct only $5.4 million of its business interest expense, equal to the sum of (1) $3 million of business interest income and (2) 30 percent of ATI or $2.4 million.

We will discuss the treatment of the disallowed interest expense of $4.6 million further below.

ATI Cannot be Less Than Zero

As noted above, IRC Section 163(j) specifically states that ATI cannot be less than zero. This provision is beneficial to the taxpayer since otherwise negative ATI would reduce any business interest income. It is also important in the context of partner/partnership limitation calculations discussed later.

Assume the same facts as the previous example, except that Debtor has a taxable loss of ($100 million) prior to deducting business interest expense. After making the same adjustments, ATI would be a loss of ($88 million). The rules limit this amount to zero. In this scenario, Debtor can deduct business interest expense of $3 million, the amount of business interest income.

Taxpayers Can Carry Forward Disallowed Business Interest Expense Indefinitely

In a previous example, IRC Section 163(j) resulted in the disallowance of $4.6 million of Debtor Inc.'s business interest expense. However, the law allows Debtor to carry forward the $4.6 million of disallowed interest expense indefinitely. This carryforward is treated as additional business interest expense in subsequent years until utilized. Debtor Inc. would test for deductibility each year using the same limitation formula discussed above.

Let's assume that Debtor Inc.'s operations improve in 2019, when it has taxable income (before interest expense) of $50 million. Once again, assume taxable income includes business interest income of $3 million and depreciation of $15 million, but there is no longer a NOL carryover. Also, Debtor Inc. accrued business interest expense of $10 million, similar to 2018. This amount is not included in taxable income as we have not calculated Debtor's allowable deduction.

Debtor's ATI would be:

Taxable income before interest expense	$ 50,000,000
Add: Depreciation	15,000,000
Less: Business interest income	(3,000,000)
Adjusted Taxable Income	$ 62,000,000
30% of ATI	$18,600,000

Debtor has the limitation capacity to deduct interest expense of $21.6 million, equal to the sum of (1) $3 million of business interest income and (2) 30 percent of ATI or $18.6 million. Accordingly, Debtor will deduct all $10 million of the interest accrued in 2019 and its $4.6 million carryforward from 2018.

As Usual, Partnerships Complicate the Picture!

For an entity that is not a taxpayer, a partnership often creates very complex issues and sometimes even opportunities in many areas of tax compliance. In the context of the business interest expense limitation, this paradox applies.

Interest Limitation Calculated at the Entity Level

Initially, the application of the new tax law appears fairly straightforward in the context of a partnership. As we noted above, the limitation itself is calculated at the entity level. And this remains true for partnerships even though they are flow-through entities. Interest expense that can be deducted at the partnership level after application of the limitation does not have to be tested again at the partner level.

Let's use Leverage Ltd., a partnership for tax purposes, as an example. Assume in 2018 that Leverage Ltd. has ATI of $50 million after adding back $9 million of depreciation. The partnership has no business interest income, but does have $20 million of business interest expense. Leverage Ltd. can deduct $15 million of its business interest expense or 30 percent of ATI (as there is no business interest income). Accordingly, Leverage reports taxable income of $26 million, which is ATI of $50 million less depreciation of $9 million and deductible business interest expense of $15 million.

Debtor Inc. is a 50 percent partner in Leverage Ltd. Accordingly, Debtor will be allocated $13 million of partnership taxable income from Leverage. Debtor's allocable share of deductible business interest expense from Leverage is not separately stated from ordinary income and does not have to be tested again with Debtor Inc. Further below, we will discuss the treatment of Leverage Ltd.'s disallowed business interest expense of $5 million.

No Double-Counting of Partnership ATI

Now things start to get more complicated when dealing with partnerships. The revised IRC Section 163(j) prevents a partner from double-counting its share of partnership ATI when determining the deductibility of business interest expense directly paid or accrued by a partner. Assume that Debtor Inc. has no business interest income and ATI of $0 exclusive of its share of activity from Leverage Ltd. Debtor accrued $4 million of business interest expense directly. Although Debtor Inc. will include its $13 million allocable share of ordinary income from Leverage in its taxable income, such amount is excluded from Debtor's ATI. So, Debtor's ATI remains at zero and the corporation cannot deduct any of its business interest expense of $4 million.

However, Excess ATI from a Partnership Can Help!

The rules are not all punitive. Partnership ATI attributable to excess limitation at the partnership level is allocated to each partner for purposes of applying the partner's limitation for any business interest expense incurred directly by such partner.

Let's revise our example involving Leverage Ltd. by increasing its ATI from $50 million to $100 million. Leverage's business interest expense limitation is now $30 million or 30 percent of ATI. Leverage can deduct all $20 million of its business interest expense. The partnership has $10 million of excess limitation. Leverage Ltd.'s ATI attributable to this excess limitation is $33 million, calculated as $10 million excess limitation/$30 million total limitation times $100 million of ATI. Debtor Inc. can include its 50 percent share of this amount in its ATI. In our example, Debtor Inc. has zero ATI from its own operations and $4 million of business interest expense. Debtor can increase its ATI to $16.5 million, its 50 percent share of Leverage's ATI attributable to excess limitation. This will allow Debtor, Inc. to deduct all of its business interest expense incurred directly as it now has a limitation of $4,950,000 (30 percent of the $16.5 million excess ATI it received from Leverage Ltd.).

In determining excess ATI at the partnership, interest expense is first offset against interest income. The remaining interest expense reduces the 30 percent of ATI to determine excess ATI. If the ordering were reversed, the partner would receive less excess ATI and business interest income would not be utilized in the calculation.

Disallowed Interest Expense of a Partnership Carried Forward by the Partners, Not the Partnership

In our initial example involving Leverage Ltd., the partnership has $5 million of disallowed interest expense. Instead of carrying disallowed interest expense forward, the law requires that the partnership allocate to each partner its share of the disallowed amount, based on the partner's allocable share of non-separately stated income. In subsequent years, the partner can deduct its share of the disqualified interest expense to the extent it is allocated any excess limitation from the partnership.

Therefore, Leverage Ltd. must report, on Debtor Inc.'s Schedule K-1, Debtor's $2.5 million share of disallowed interest expense, or 50 percent of $5 million. In subsequent years, Debtor Inc. can deduct the $2.5 million interest expense against any ATI attributable to excess limitation allocated to it from Leverage Ltd. Note that Debtor Inc. can only deduct this disqualified interest against future excess limitation from Leverage Ltd., not from any other partnership or its own ATI.

Disallowed interest expense of a partnership is allocated to each partner, who then carries such amount forward.

The specific language in IRC Section 163(j) regarding ATI attributable to excess limitation from a partnership is somewhat confusing. The language suggests that the partner can deduct the disallowed interest expense carryover to the extent it is allocated excess ATI from a partnership. Presumably, the intention is that the interest can be deducted against 30 percent of such amount, although this is not clear in the language. Hopefully, future guidance from the IRS will clarify this.

How does the disallowed interest expense impact Debtor's tax basis in Leverage Ltd.? IRC Section 163(j) requires Debtor to reduce its tax basis in Leverage by $2.5 million in 2018, even though Debtor, Inc. will not benefit from this disallowed interest expense until future years, if at all. This could impact the amount of losses Debtor can recognize from Leverage Ltd. in future years. If Debtor subsequently disposes of its investment in Leverage prior to utilizing this carryforward amount, it can increase its tax basis in Leverage immediately before the disposition by any unused portion.

A Final Word on Partnerships

A corporation, through the use of subsidiaries, has the ability to operate a business through a partnership while effectively maintaining 100 percent ownership. IRC Section 163(j) does not distinguish between partnerships held by unrelated partners and wholly owned partnerships. This presents planning opportunities with regard to placement of debt. Absent guidance from the IRS, the operating rules of Section 163(j) indicate the following:

- If the ATI limitation at the partnership equals or exceeds interest expense, there is no incentive to move debt to the partner. Any excess ATI is not wasted, but is allocated to the partners. The consolidated group rules discussed below make the allocation between partners of no consequence.
- If interest expense within a partnership exceeds the limitation, the corporation should consider restructuring the debt to place at least a portion of the balance at the partner level if the partner has excess limitation.
- If neither the partner nor partnership has excess limitation, the placement of debt at the partnership level should not exceed the limitation since disallowed interest expense at the partnership level can only be utilized against excess limitation from the partnership that is later allocated to the partners. But disallowed interest expense at the partner level can be utilized with excess limitation of the partner or excess limitation allocated to the partner from the partnership in future years.
- Corporations should consider restructuring wholly owned partnerships to increase ATI in partnerships with debt. Splitting a partnership into two partnerships might allow for greater capacity to utilize interest expense.

For example, if a partnership contains one profitable facility (A) and one unprofitable one (B), separating the facilities into two separate entities would increase the limitation for A. And the ATI of B cannot be less than zero, so there is no reduction in the ATI of the partners.

Application to Other Pass-Through Entities

With one exception, the partnership limitation provisions apply to S corporations. The limitation is still calculated at the S corporation level. To the extent ATI is used by the S corporation to deduct business interest expense, it cannot be included in the shareholder's ATI to offset interest expense from other sources. Also, similar to a partnership, a shareholder can use its allocable share of excess limitation from an S corporation. Where the two pass-through entities differ is with regards to disallowed interest expense. As we discussed above, disallowed interest expense of a partnership is allocated to each partner, who then carries such amount forward. Disallowed interest remains with an S corporation, which carries it forward until it has sufficient limitation to deduct it.

There is no mention of entities treated as sole proprietorships (e.g., default classification of single member LLCs) in IRC Section 163(j), although presumably business interest expense in these entities would be subject to the same limitation. The law does refer to ATI excluding the new special pass-through deduction, which would only apply to individuals.

In addition, IRC Section 163(j) specifically excludes services of an employee from the definition of a trade or business, implying that other activities by an individual could be subject to the limitation. Also, investment interest income and expense are specifically excluded from the definitions of business interest income and business interest expense, respectively. Investment interest income and expense is a concept unique to individuals from a tax perspective. Practically though, the small business exception applicable when average gross receipts for the three previous years does not exceed $25 million would eliminate most sole proprietorships from this limitation.

Going Forward

Future IRS Guidance

Taxpayers and their advisors are anticipating additional guidance from the IRS with regards to the limitation on business interest expense. In March 2018, the IRS issued Notice 2018-18. In this notice, the IRS indicated that future regulations will clarify that:

- All of the taxable interest income and otherwise deductible interest expense of a corporation will be considered business interest income and expense for purposes of the revised IRC Section 163(j). A corporation does not have investment interest income or expense for purposes of this limitation.
- The limitation will apply on a consolidated basis for corporations filing a consolidated tax return. However, the limitation will be computed separately for members of an affiliated group not filing a consolidated tax return.
- Interest expense disallowed in prior years under the old IRC Section 163(j) can be carried forward to 2018 and treated as business interest expense paid in 2018. This interest will be subject to the new limitation.
- Guidance in regulations will be issued addressing the interaction between the new limitation and the new base erosion avoidance tax for interest paid to related parties disallowed under the older IRC Section 163(j) and carried forward to 2018.
- Disallowed interest under IRC Section 163(j) will still reduce a corporation's earnings and profits.
- The new law specifically states that ATI from a partnership cannot be double-counted by a partner to deduct additional business interest expense at the partner level. Although IRC Section 163(j) is silent with regards to a partner's allocable share of business interest income from a partnership, the regulations will clarify that a partner cannot double count this income either.

Proactive Planning is Necessary

Businesses will certainly need to model taxable income and interest expense to determine the likelihood of a potential disallowance of a tax deduction for all or part of its business interest expense going forward. For many businesses, such analysis will show that no disallowance is expected. However, for leveraged taxpayers, especially ones in cyclical industries, a disallowance may be a possibility.

This could drive decisions on whether to finance operations with debt or equity. And if partnerships or unconsolidated groups are involved, the placement of debt within an organization could be critical. There are other issues for taxpayers to consider.

Capital Expenditures and Depreciation Elections

For capital-intensive businesses, the limitation becomes more severe for tax years beginning after January 1, 2022 when ATI is no longer increased by depreciation, depletion or amortization. While focusing on this change may be premature given Congress' history of modifying tax law to accommodate the bonus depreciation rules, as 2022 approaches, taxpayers should be prepared to analyze both (1) the timing of capital expenditure decisions (especially between 2021 and 2022) and (2) the potential

election of ADS depreciation instead of MACRS.

While depreciation is a timing issue and disallowed interest expense can be carried forward indefinitely, leveraged companies with substantial capital needs likely will not see large swings in either depreciation expense or interest expense. Accordingly, taking the maximum depreciation deduction may indirectly result in a limitation of interest expense that becomes indefinite in timing.

Financial Reporting Implications

We will make a final note regarding financial reporting. Businesses that prepare financial statements, especially those prepared under generally accepted accounting principles, will need to consider any financial reporting implications of disallowed interest expense. Since disallowed interest expense can be carried forward indefinitely, it will result in a deferred tax asset.

However, a taxpayer would then need to assess if it was more likely than not that some or all of the deferred tax asset would not be realized, thus requiring a valuation allowance. The modeling for this analysis will be complicated as it needs to encompass several factors, including (1) future operating income, (2) a reliable forecast of future debt levels and associated interest expense, (3) anticipated business interest income, (4) estimated capital expenditures and (5) available options for cost recovery.

The purpose of this article has been to examine the restrictions of the new tax act on the deductibility of interest expense in businesses and to consider how taxpayers might structure their operations to minimize the impact.

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We Made an S Election to Save Self-Employment Taxes

By **MARCUS J. BROOKS** and **TRIP DYER**

Above is the most oft-cited reason for having partnership-eligible state law entity, typically a limited liability company (LLC), make an S election. There are times that this principle holds up. There are, however, many situations in which it does not bear out. There are also situations in which any self-employment tax savings from making an S election may be outweighed by restrictions on, or consequences of, S corporation status, which do not apply to entities taxable as partnerships.

In this article, we will try to set forth some more-or-less quantitative measures by which to evaluate that proposition, as well as considering whether a traditional limited partnership (LP) or multi-entity planning might reach a more optimal overall result.

Self-Employment Tax

Individuals are generally subject to self-employment tax on their self-employment income. In 2017, the self-employment tax rate was 15.3 percent on self-employment income up to $127,200 and 2.9 percent on all income in excess of $127,200. An additional 0.9 percent Medicare tax is imposed on self-employment income exceeding $250,000 for married couples filing jointly, $125,000 for married couples filing separately and $200,000 for single filers. In the aggregate, this results in a 3.8 percent rate on high income taxpayers for all self-employment income over and above the aforementioned limits.

Self-employment income, or "net earnings from self-employment," includes the gross income derived by an individual from any trade or business conducted as a sole proprietorship or partnership in which the individual is a partner, less certain deductions. However, in determining an individual's self-employment income, there is a specific exclusion for a limited partner's allocable share of income from a partnership other than guaranteed payments made to a limited partner for services provided to a partnership.

Section 1402(a)(13) was passed in 1977, before the advent of LLCs and limited liability partnerships (LLPs). Prior to its enactment, a limited partner's share of partnership income was treated as self-employment income. The legislative history indicates that the purpose of section 1402(a)(13) was to prevent limited partners who performed no services for a partnership from accruing Social Security benefits. Guaranteed payments for services actually performed by a limited partner for the partnership, however, were subject to self-employment taxes. The statute was thus designed as a "blocker" from persons who ostensibly desired to

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pay self-employment taxes without performing services and receive credit for Social Security purposes, rather than as a tax planning technique to avoid self-employment taxes.

The legislative history also indicates that where the same person is a limited partner and general partner in the same partnership, the income attributable to the general partner interest would be subject to self-employment tax, but the income attributable to the limited partner interest would not.

The Limited Partner Exclusion, as Applied to LLCs, LLPs, etc.

Although the limited partner exclusion in section 1402(a)(13) may appear to be a useful vehicle for escaping self-employment taxes, its application to persons other than traditional limited partners in a state law LP has been uncertain, at best. A string of cases and rulings indicates that the IRS is not willing to accept the limited partner exclusion at face value, particularly in situations involving LLCs and LLPs. Courts have then struggled to draw uniform principles that would guide taxpayers in these situations. A review of a few of the cases in this area is instructive.

A string of cases and rulings indicates that the IRS is not willing to accept the limited partner exclusion at face value …

Renkemeyer, Campbell & Weaver LLP v. Comm'r, 136 TC 137 (2011) may be the most discussed case in this area. In Renkemeyer, the Tax Court held that partners of a law firm, which was organized as an LLP (under state law, a general partnership in which all partners are shielded from liability) were subject to self-employment taxes on their shares of partnership income. The partners argued that the limited partner exclusion applied, because their interests were designated as limited partnership interests in the partnership agreement and they had limited liability under state law. The Tax Court noted that section 1402(a)(13) does not define "limited partner" and that the meaning of the term has been obscured as new types of flow-through entities, such as LLCs and LLPs, became commonplace.

Because the legislative history of section 1402(a)(13) indicates that the purpose of the limited partner exclusion was to ensure that merely passive investors would not receive credits towards Social Security coverage, the court found that the limited partner exclusion should not apply to partners who performed services for a partnership in their capacity as partners. The partners were subject to self-employment tax on all of their partnership income, because their earnings were not of an investment nature; their income all arose from their legal services and they made only nominal capital contributions to the partnership. The court did not rest its holding on the notion that partner in an LLP could not be "limited partners," nor did it deal with the concept of guaranteed payments.

Howell v. Comm'r, TC Memo 2012-303, addressed the application of section 1402(a)(13) as it applied to a member of a California LLC holding a medical technology company that was operated by a husband and wife as members. The Tax Court followed the general approach of Renkemeyer, but arguably added some important nuance. The taxpayers initially characterized payments made to Mrs. Howell as guaranteed payments, which would on its face bring the payments outside of the exclusion. At trial, the taxpayers took the position that these payments were not "guaranteed payments" and should thus be recharacterized.

The Tax Court concluded that Mrs. Howell performed services for the company, was not "merely" a passive investor and that the payments were at least "to some extent" payments for services rendered. Because the taxpayers did not attempt to establish that only some portion of the payments was remuneration for services rendered, the court found wholly for the IRS.

Again, this opinion does not close the door on the idea that LLC members (even working LLC members) might utilize the limited partner exclusion. If the simple fact that Mrs. Howell performed services had taken her out of the limited partner exclusion, by definition, then the guaranteed payment analysis provided for in the statute would not have been necessary. This opinion at least raised the question of whether an LLC member's compensation can be bifurcated, with some being for services rendered and thus subject to self-employment taxes, while other amounts may be due to ownership/investment and subject to exclusion under section 1402(a)(13).

Castigliola v. Comm'r, TC Memo 2017-62, addressed whether the limited partner exclusion applied to members of a law firm organized as a member-managed LLC, who had improved on the taxpayers' arguments in Renkemeyer and Howell by paying themselves guaranteed payments that were commensurate with local legal salaries. These members took the position that their shares of LLC income above such payments were excluded from self-employment taxes under section 1402(a)(13).

The Tax Court, generally following the Renkemeyer approach, determined whether the members of the LLC held a position that was "functionally equivalent to that of a limited partner in a limited partnership." Because each member in Castiogliola actively participated in the management of the business, the Tax Court held that they were not limited partners under section 1402(a)(13). The court reasoned that, since by necessity at least one of members must have occupied role analogous to that of general partner in a limited partnership and because all of the members had the same rights and responsibilities, they must all have had positions analogous to those of general partners. As a result, all of their LLC income was subject to self-employment taxes.

The court did not analyze to what extent the members' remuneration was or was not due to services rendered, as in the Howell analysis, but rather rested its entire holding on the determination that the members were more like general


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partners than limited partners. The easily asked question here is whether this analysis changes for a manager-managed LLC, where the members do not have responsibilities commensurate with a general partner.

We do know that there are situations in which an LLC member can effectively utilize the limited partner exclusion. In Hardy v. Comm'r, TC Memo 2017-16, the Tax Court addressed a fact pattern in which a surgeon was a minority member of an LLC that operated a surgical center. When the surgeon/member performed surgeries at the surgical center, patients would pay two fees: one to the surgeon/member for the surgery and one to the surgical center for use of the facility. The Tax Court noted that he was "not involved in the operations of the LLC as a business" and held that his share of LLC income (which was solely attributable to the surgical center fees) was not subject to self-employment tax because "he received the income in his capacity as an investor."

Taken together, these opinions establish that:

- An LLC member may be a "limited partner" under section 1402(a)(13) and
- Amounts paid to an LLC member based on such member's "investment" rather than in remuneration for services can fall under the exclusion.

The guaranteed payment analysis in Howell, as well as the language of section 1402(a)(13) itself, raises at least a reasonable argument that an LLC member who is a "limited partner" (e.g., an individual who is a member, but not a manager, of a manager-managed LLC) should be able to reasonably bifurcate his/her income between guaranteed payments for services, which would be subject to self-employment tax, and investment income, which would fall under the limited partner exclusion.

Net Investment Income Tax and Its Application to Partnerships

A taxpayer reporting income from an LLC taxed as a partnership may be able to escape self-employment taxes by utilizing some form of the Hardy passive investor strategy, but in so doing may simply walk into the net investment income tax (NIIT). The NIIT is imposed, in addition to income tax, at a 3.8 percent rate on the lesser of an individual's net investment income or adjusted gross income above certain thresholds, which thresholds are identical to those described above for the 0.9 percent Medicare tax on self-employment income. The NIIT essentially mirrors the uncapped self-employment tax burden described above.

Net investment income includes income from interest, dividends, annuities, royalties and rents. Importantly, it also includes income from a trade or business that is a passive activity within the meaning of section 469 with respect to a taxpayer. Under section 469, a passive activity is any trade or business in which a taxpayer does not materially participate.

Generally, a limited partner is not treated as materially participating in an activity unless he/she participates for more than 500 hours in a taxable year. A taxpayer who acts as a passive investor to escape self-employment taxes, like the surgeon in Hardy, could instead subject himself/herself to NIIT. The self-employment tax and NIIT rates on income above the threshold amounts are identical, so, with the exception of self-employment taxes up to the threshold amount, use of the limited partner exclusion by a passive taxpayer generally does not result in a significant tax savings.

Let's briefly consider this in conjunction with the hypothetical posited above – i.e., that an LLC member who is a "limited partner," (e.g., in a manager-managed LLC) should be able to support a reasonable bifurcation of income into the guaranteed payment for services bucket, on the one hand, and the investment bucket on the other. The latter portion (investment bucket) would not be subject to self-employment taxes. Would that latter portion then be subject to NIIT? Arguably, it would not, assuming the taxpayer materially participated in the LLC's trade or business, as it does not arise from a trade or business that is a passive activity with respect to a taxpayer.

Section 1411(c)(2)(A), describing activities that give rise to net investment income, states that "a trade or business is described in this paragraph if such trade or business is a passive activity (within the meaning of section 469) with respect to the taxpayer." Remember, the taxpayer is indisputably active and receiving a guaranteed payment for services. So, in this example, the LLC member has arguably succeeded in:

- Bifurcating its LLC compensation for self-employment tax purposes and
- avoiding the NIIT.

That said, it is not a stretch to say that the law in this area remains "messy" and, unfortunately, the definitive case is not yet out there. To fall squarely within the statute and avoid the uncertainty surrounding LLCs and LLPs, a traditional LP might be utilized instead. Section 1402(a)(13) clearly allows for a limited partner to bifurcate his/her income between guaranteed payments and investment income, avoiding self-employment tax on the latter. Assuming a limited partner materially participates in the LP's trade or business, he/she could avoid paying NIIT on his/her distributive share of income from the partnership, as well.

Additionally, an individual could arguably retain a role in management as a general partner without jeopardizing the exclusion of his/her limited partner income from self-employment tax based on the legislative history of Section 1402(a)(13). For these reasons, LPs are a viable option for self-employment tax and NIIT planning without making an S election, even though they may sometimes be less desirable than an LLC for non-tax reasons.

Self-Employment Tax and NIIT as Applied to S Corporation Owners

While S corporations do come with a variety of trade-offs and limitations, one thing that they do offer is relative clarity in this area. Unlike sole proprietorships and partnerships, a shareholder's share of income from an S corporation is not subject to self-employment taxes. A shareholder's share of income may, however, be subject to NIIT if the trade or business is a passive activity with respect to the shareholder. As a result, a passive shareholder of an S corporation would be subject to NIIT, just like a passive limited partner who utilized the limited partner exclusion to avoid self-employment taxes.

An S corporation shareholder can avoid both self-employment taxes and NIIT, though, if the trade or business is not a passive activity. If the shareholder materially participates in the activity under the rules of section 469, his/her

> An S corporation must pay a shareholder who is active in the business reasonable compensation that is subject to payroll taxes.

share of income from the S corporation generally is not considered net investment income. Likewise, a shareholder's share of income from an S corporation is not subject to self-employment taxes.

There is one important gating issue to the above treatment – an S corporation must pay a shareholder who is active in the business reasonable compensation that is subject to payroll taxes. Because S corporation income is not subject to self-employment taxes, but compensation paid to an employee is subject to payroll taxes, S corporations with shareholder-employees are incentivized to forgo paying compensation and instead make distributions to its shareholders-employees.

Recognizing this, the IRS has taken to recharacterizing distributions made to shareholder-employees as compensation. A discussion on determining reasonable compensation for a shareholder-employee of an S corporation is beyond the scope of this article, but many factors should be considered, including the employee's qualifications, experience, and job scope and market compensation for similar positions. A tax advisor may consider factors found in cases in the C corporation context, where the IRS tends to argue that compensation paid to a shareholder is too high.

Other Considerations in Making an S Election/Multi-Entity Planning

In addition, S corporations have other disadvantages which must be weighed against any benefit derived in the self-employment tax/NIIT arena. S corporations are limited to 100 shareholders, all of whom must be US residents and individuals or certain types of trusts or estates. Businesses that have equity owners that are taxable as partnerships or corporations or that are nonresident aliens are not eligible to make an S corporation election.

Further, S corporations are limited to one class of stock. This means that each share of stock issued by an S corporation must have identical rights to distributions and proceeds from liquidation. Essentially, all distributions from S corporations must be made to the shareholders pro rata in accordance with percentage ownership.

Many distribution waterfall provisions common to LPs and LLCs, such as non-pro rata preferred returns or carried interests, are forbidden for S corporations. As a result, S corporations cannot issue profits interests to key employees that it would like to incentivize with equity ownership.

S corporations also have a more difficult task attracting outside investors, because many investors are organized as partnerships and are not eligible shareholders, and the corporation is hamstrung by the single class of stock requirement. Beyond the eligibility issue, purchasers of an S corporation interest do not receive a section 743 step-up in the inside basis in the entity's assets, as do the purchasers of a partnership interest. Additionally, built-in gain property (e.g., appreciated real estate or intellectual property) can present substantial difficulties in an S corporation, because moving it out of the S corporation structure may result in a deemed sale and taxable gain under section 311(b).

In this context, multi-entity planning should not be ignored. There may well be situations in which the S election drives certainty and self-employment tax/NIIT savings sufficient to justify the election, but in which other effects of the S election need to be mitigated. To manage the S corporation restrictions, one possibility is for an S corporation to form a subsidiary in the form of an LLC. The subsidiary, which would not be subject to the same organizational rules as the S corporation, would be able to offer employees profits interests. It would also be positioned to bring in equity investors, no matter their organizational structure or residency, for any economic terms that are negotiated and to provide them with a section 743 step-up as to the assets underneath the partnership structure.

A subsidiary would also allow built-in gain property to be moved around as necessary within the partnership structure (though not outside of the upstream S corporation) without recognition of gain. The principal shareholder could avoid self-employment taxes and NIIT on his/her distributive share of S corporation income (which would flow through the subsidiary to the S corporation), as long as he/she materially participates in the trade or business and was paid a reasonable salary by the S corporation.

Consider the Drawbacks

An S election can certainly offer savings, given the correct situation, and certainty with respect to self-employment taxes and NIIT. However, the amount of those savings should be quantified, as far as possible, and weighed against the potential drawbacks of making an S election. Those drawbacks may be significant or insignificant, depending on the type of business, property, investors and long-term strategy involved.

When substantial competing interests come into play here, do not forget to consider a traditional LP or whether a multi-entity strategy can provide the best overall solution. While there are reasonable arguments that the proper use of an LLC taxed as a partnership should get you to the same self-employment tax and NIIT treatment as an S corporation, the state of the law regarding self-employment tax and NIIT as it relates to any entity taxed as a partnership, other than an LP, unfortunately remains unclear.

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CPE ARTICLE

Safe Harbor Rules For Calculating Casualty Losses For Victims Of Federally Declared Disaster Areas

By **VALRIE CHAMBERS**, Ph.D., CPA; **GERARD H. SCHREIBER, JR.**, CPA; and **BRIAN ELZWEIG**, JD, LL.M.

CURRICULUM: Tax

LEVEL: Intermediate

DESIGNED FOR: Designed primarily for tax practitioners, but there are issues that may be of interest to all in public practice

OBJECTIVES: With the current tax law, the Disaster Tax Relief and Airport and Airway Extension Act of 2017, the IRS Rev. Procs. 2018-8 and 2018-9, the Tax Cuts and Jobs Act of 2017 and the Bipartisan Budget Act of 2018, claiming casualty losses can be confusing. This article attempts to integrate these sources of guidance to assist tax preparers in determining the appropriate amount of the personal casualty loss deduction for individual taxpayers, including safe harbor provisions for recent storms.

KEY TOPICS: Tax law, casualty losses, safe harbors and hurricane tax preparation

PREREQUISITES: None

ADVANCED PREPARATION: None

In 2017, Americans saw three devastating hurricanes – Harvey, Irma and Maria – accompanied by flooding and other associated destruction of property. These storms created total damage estimates of $90 billion, $45 billion and $102 billion respectively.[1] Recent tax changes limit the ability to take some casualty losses. However, the deductibility of casualty losses in federally declared disaster areas remains intact, so this topic is still quite relevant.

The IRS has devised a choice of several safe harbors to make accounting for casualty losses beginning in 2018 different and in some ways easier. Weather experts predict a somewhat more active hurricane season this year (and into the future) and there was already one named storm ahead of the official start of hurricane season.

With the current tax law, the Disaster Tax Relief and Airport and Airway Extension Act of 2017,[2] the IRS Rev. Procs. 2018-8 and 2018-9, the Tax Cuts and Jobs Act of 2017[3] and the Bipartisan Budget Act of 2018,[4] claiming casualty losses can be confusing. This article attempts to integrate these sources of guidance to assist tax preparers in determining the appropriate amount of the personal casualty loss deduction for individual taxpayers.

Cleaning costs, appraisal fees, treatment of personal injuries, temporary housing and replacement cost of damaged property are not included in the amount of casualty loss calculation.

Casualty Loss Rules Generally

A casualty loss is the damage, destruction or loss of property owned by a taxpayer caused by an external force that is sudden, unexpected ***and*** unusual.[5] Where a home located in a federally declared disaster area is made unsafe by a disaster and requires demolition or moving the home, the loss in value is a disaster loss provided that the tear-down order was issued within 120 days after the official disaster declaration.

The amount of the deductible casualty loss is limited to direct damage to the property. In the case of Hurricane Harvey where there was both a hurricane and a flood, the damage from multiple related casualty and thefts is treated as caused by a single casualty. Because losses are determined per taxpayer, losses for two individuals filing jointly are treated as one loss.[6]

The amount of the casualty loss is the lesser of the taxpayer's basis in the damaged property or the decrease in its fair market value (FMV), as determined by a competent appraisal.[7] The term "competent appraisal" is not well-defined; different types of appraisal are likely valid. In *Torassa and Sintef v. Commissioner,*[8] a Small Business Administration appraisal was accepted by the Tax Court. The decrease in FMV is the amount of the property's FMV immediately before the casualty less the property's FMV immediately after it. When using the cost of repairs to estimate casualty loss damage, the taxpayer must actually make the repairs.[9] Cleaning costs,[10] appraisal fees,[11] treatment of personal injuries, temporary housing and replacement cost of damaged property are not included in the amount of casualty loss calculation. Casualty losses are allowed on passive activities without regard to passive loss limitations.[12]

Adjusted basis is generally the cost of a piece of property,[13] as adjusted for any expenditure, receipt, loss or other item, properly chargeable to capital account, including the cost of improvements and betterments made to the property.[14] The cost includes sales tax, delivery, installation, settlement costs and other similar items, improvements that increase the length or quality of an asset's life, assessments for local improvements, legal fees for defending and perfecting title, and zoning costs. Decreases to basis include tax credits taken for costs of property, Section 179 election to expense property, previous net casualty or theft loss deductions.[15]

The amount of casualty loss is the value of the damage minus the amount of reimbursement received or expected to be received from insurance and other outside sources.[16] Losses on insured property are deductible only if a timely insurance claim for reimbursement was indeed filed; otherwise, only the portion of the loss *not* covered by insurance is deductible.[17]

Where reimbursements are used to satisfy a mortgage or other lien, the reimbursement still reduces the amount of the casualty loss. Where another party repairs or rebuilds an individual's personal-use residential real property at a *de minimis* or zero cost to the individual, the casualty loss is reduced by the value of those "no-cost repairs." If part of a federal disaster loan is canceled under this provision, it is considered reimbursement for the casualty loss.

Grants received under the Disaster Relief and Emergency Assistance Act reduce the casualty loss only to the extent that the grant specifically reimburses for the property loss.[18] Money received from an employer's emergency disaster fund is considered a reimbursement similar to insurance proceeds if that money must be used to rehabilitate or replace damaged property. Disaster relief, including food and medical supplies, does not reduce the amount of the casualty loss, nor do unrestricted cash gifts, as might be received by an online fundraising account (such as a GoFundMe account) or personal gift.

If a taxpayer receives reimbursement for a deductible casualty loss in a year after taking the deduction, the amount of the reimbursement will be included in gross income in the year received to the extent that it represented an itemized deduction in excess of the standard deduction amount.[19] If includible reimbursements exceed casualty losses, a taxpayer may actually have a casualty gain, such as when the taxpayer carried replacement value insurance. Casualty gains may be deferred under IRC §1033 or in the case of some personal residences that are subsequently sold, non-taxable under IRC §121.

Once the amount of the casualty loss is determined, limitations, if any, must be applied.[20] If the casualty loss is on business property, the net casualty loss is the deductible amount. Income producing property, like land held for investment and property used by an employee in the course of employment, is treated under the profit-seeking rules.[21] If the casualty loss arises from an activity not entered into for a profit, such as for personal-use property, two additional limits to casualty loss deductibility applied prior to 2018, a nominal amount per incident floor[22] and 10 percent of the taxpayer's adjusted gross income (AGI) per year.[23] The net casualty losses on personal-use property were deductible as an itemized deduction. Property with multiple uses must be allocated ratably according to their uses. The property need not be replaced to be deductible.[24]

Federally Declared Disaster Areas

Victims in a federally declared disaster area[25] receive additional tax relief. They may file the casualty loss against the tax year in which the casualty loss occurred or claim the casualty loss against the previous year's return.[26] Taxpayers generally elect to apply a casualty loss to the previous year on or before the date that is six months after the regular due date for the original return (without extensions) for the disaster year.[27] This election is revocable if, within 90 days after election, any refund or credit received attributable to the election is returned to the IRS with interest or if the revocation is made before the refund has been received. The IRS generally abates interest and penalties for amounts due on returns extended because the taxpayer is in a federally declared disaster area.

For qualified disasters, such as those arising from Hurricanes Harvey, Irma and Maria, losses can be deducted for both regular and alternative minimum taxes, whether the taxpayer itemizes or uses the standard deduction and are not subject to the 10 percent of Adjusted Gross Income limitation, but are subject to a $500 per incident floor.

Supporting Documentation

The taxpayer may have to substantiate the type of casualty, the date(s) of casualty and whether the property was owned by the taxpayer, or when not owned, the amount of the taxpayer's liability to the owner for damage. The taxpayer generally must be able to substantiate the bases for the value and the pre-casualty condition of the properties. Where the taxpayer's supporting documentation has been destroyed, copies can sometimes be obtained from third parties like banks, a county clerk (real estate records) and the IRS (copies of federal tax returns).

Litigation with the IRS could arise when taxpayers have difficulty determining the amount of their casualty losses under Reg. Sec. 1.165-7(a)(2). Guidance on the use of estimates, where necessary, can be found in AICPA's Statement on Standards for Tax Services No. 4 – Use of Estimates.[28]

Recently, the IRS has provided new safe harbors for calculating the amount of casualty losses, including for victims of Hurricanes Harvey, Irma and Maria. Use of these safe harbor methods is not mandatory and the IRS will not challenge the decrease in FMV to the extent an individual qualifies for and uses one or more of these methods. Safe harbors serve the IRS mission of providing effective tax administration.

Use of these safe harbor methods is not mandatory and the IRS will not challenge the decrease in FMV to the extent an individual qualifies for and uses one or more of these methods.

New Safe Harbor Rule

Individuals having substantiation for their casualty losses may use their actual losses or one of the safe harbor methods outlined in the revenue procedure.[29] Rev. Proc. 2018-8, issued December 13, 2017 (nine days before the passage of the Tax Cuts and Jobs Act), provides safe harbor methods to determine the amount of individual casualty and theft losses to personal-use property resulting from any federally declared disaster.[30] The guidance is effective December 13, 2017.[31]

The revenue procedure provides different guidelines for residential real property than for personal property. Personal-use residential real property is defined as real property that has at least one personal residence, including permanent improvements such as buildings, ornamental trees and shrubbery. Personal-use residential real property does not include a personal residence which, in whole or part, is used as rental property or contains a home office used in a trade or business or transaction entered into for a profit.

A personal residence can be a single-family home, townhome or duplex, but not a condominium, cooperative unit or any other structure where the individual who suffered the casualty loss does not own or owns only a fractional component of the structural components of the building, such as the foundation, walls and roof.[32]

Personal-use Residential Real Property

The five general personal-use residential real property safe harbor methods are: 1) Estimated Repair Cost Safe Harbor Method, 2) the De Minimis Safe Harbor Method, 3) the Insurance Safe Harbor Method, 4) the Contractor Safe Harbor Method, and 5) the Disaster Loans Safe Harbor Method. The Insurance Safe Harbor Method and the Contractor Safe Harbor Method parallel the safe harbor methods of the same name available for Hurricanes Katrina, Rita and Wilma.[33] There is also a Cost Index Safe Harbor Method for victims of Hurricane Harvey, Irma and Maria, as was similarly available for Hurricanes Katrina, Rita and Wilma, found in Rev. Proc. 2018-9. If an individual owns two or more parcels of personal-use residential real property, different methods may be used for each real property.[34]

Estimated Repair Cost Safe Harbor Method

Under this method, for individuals with casualty losses of $20,000 or less before considering the casualty loss limitations, the decrease in FMV may be estimated by using the lesser of two itemized repair estimates prepared by separate and independent licensed contractors. Only the costs to restore the individual's property to the condition existing immediately prior to the casualty loss are deductible; the costs of improvements or additions that increase the value of the property above its pre-casualty value, such as might be incurred to meet new construction codes, must be excluded from the estimate for safe harbor purposes.[35]

De Minimis Safe Harbor Method

If the amount of loss before applying the dollar amount and 10 percent AGI limitations is less than $5,000, the individual may simply make a good faith estimate of the decrease in the FMV of the belongings, provided they maintain records describing the personal belongings that were affected and the method for estimating the loss.[36]

Insurance Safe Harbor Method

Under the Insurance Safe Harbor Method, an individual taxpayer may use the estimated loss determined in reports prepared by the individual's homeowners' or flood insurance company to determine the decrease in fair market value of an individual's personal-use residential real estate.[37]

Contractor Safe Harbor Method

Under the Contractor Safe Harbor Method, an individual may estimate the decrease in FMV using the contract price from a licensed contractor for the itemized costs to restore the individual's personal-use residential real property to the condition it was in immediately prior to the hurricane repairs. The costs of any improvements or additions that increase the value of the personal-use residential real property above its pre-hurricane value or to elevate the personal residence to meet new construction requirements, must not be included in the casualty loss amount. To use the Contractor Safe Harbor Method, the contract must be a binding, signed contract.[38]

Disaster Loan Appraisal Safe Harbor Method

Under the Disaster Loan Appraisal Safe Harbor Method, an individual may use an appraisal prepared to obtain a loan of federal funds or a loan guarantee from the federal government as an estimate of the loss that the individual sustained.[39]

Continued on page 48

TSCPA CPE COURSE CALENDAR | OCTOBER AND NOVEMBER

For more information, number of CPE credit hours and to register, go to the CPE section of the website at tscpa.org or call the TSCPA staff at 800-428-0272 (972-687-8500 in Dallas) for assistance.

DATE	COURSE	CITY
October 1-2	2018 Single Audits & Governmental Accounting Conference	Austin
October 17	Personal & Professional Ethics for Texas CPAs	Dallas
October 18	Financial Statement Presentation and Disclosures: A Realistic Approach	Houston
October 18	Yellow Book: Government Auditing Standards	Dallas
October 19	Personal & Professional Ethics for Texas CPAs	Houston
October 19	New! Real World Fraud Found in Governments and Not-for-Profits	Dallas
October 22	Yellow Book: Government Auditing Standards	Houston
October 22	Federal Tax Update	Dallas
October 23	Social Security, Medicare and Prescription Drug Retirement Benefits: What Every Baby Boomer Needs to Know	Dallas
October 23	New! Real World Fraud Found in Governments and Not-for-Profits	Houston
October 23	Texas Franchise Tax	Fort Worth
October 24	Annual Accounting Update for Accountants in Industry	Houston
October 24	Federal Tax Update	Fort Worth
October 25	Social Security, Medicare and Prescription Drug Retirement Benefits: What Every Baby Boomer Needs to Know	Fort Worth
October 26	Annual Accounting Update for Accountants in Industry	Dallas
October 26-27	2018 Accounting Education Conference	Richardson
October 29	Federal Tax Update	Austin
October 30	Social Security, Medicare and Prescription Drug Retirement Benefits: What Every Baby Boomer Needs to Know	Austin
November 2	LLC and Partnership Tax Planning Strategies After Tax Reform	Houston
November 5	Federal Tax Update	San Antonio
November 5	Annual Update for Accountants and Auditors	Dallas
November 6	Auditing Employee Benefit Plans	Dallas
November 6	Social Security, Medicare and Prescription Drug Retirement Benefits: What Every Baby Boomer Needs to Know	San Antonio
November 6	Personal & Professional Ethics for Texas CPAs	Houston
November 8	Federal Tax Update	Houston
November 9	Social Security, Medicare and Prescription Drug Retirement Benefits: What Every Baby Boomer Needs to Know	Houston
November 9	LLC and Partnership Tax Planning Strategies after Tax Reform	Dallas
November 9	Annual Tax Planning Guide for S Corporations, Partnerships and LLCs	Corpus Christi
November 12	Preparation, Compilation and Review Annual Update and Review	Dallas
November 12	Annual Update for Accountants and Auditors	Houston
November 12	LLC and Partnership Tax Planning Strategies after Tax Reform	Fort Worth
November 12	Yellow Book: Government Auditing Standards	Austin
November 13	Auditing Employee Benefit Plans	Houston
November 13	New! Real World Fraud Found in Governments and Not-for-Profits	Austin
November 14	Preparation, Compilation and Review Annual Update and Review	Houston
November 14	Personal & Professional Ethics for Texas CPAs	Dallas
November 15-16	2018 Texas CPA Tax Institute	Addison
November 15-16	2018 Texas CPA Tax Institute	San Antonio
November 26	Handbook for Mastering Basis, Distributions and Loss Limitation Issues for S Corporations, LLCs and Partnerships	Dallas
November 27	Efficient and Effective Form 1040 Review: The Next Step for Valuable Staff	Houston
November 28	Handbook for Mastering Basis, Distributions and Loss Limitation Issues for S Corporations, LLCs and Partnerships	Houston
November 29-30	2018 CPE EXPO Conference	Dallas

Cost Index Safe Harbor Method

Under the Cost Index Safe Harbor Method, an individual who was a victim of Hurricanes Harvey, Irma or Maria may determine the amount of the decrease in FMV for casualty losses for their personal-use residential real property damaged or destroyed using government-issued tables. As with the other safe harbor methods, the IRS will not challenge a qualifying individual's determination of a decrease in value where the tables were properly applied.

There are seven tables that can be found in Rev. Proc 2018-9 that give the safe harbor cost per square foot indices for total losses, near total losses, interior flooding (of over one foot), structural damage from wind, rain and debris, roof covering damage from wind, rain and debris, damage to a detached structure and damage to decking. The cost indices are specific to the state or territory in which the damage occurred.

Personal Belongings Safe Harbor Methods

Individuals may use a personal belongings safe harbor method for most tangible personal property that they own that is not used in a trade or business or transaction entered into for a profit. However, this safe harbor method is not applicable if that property is a boat, aircraft, mobile home, trailer, vehicle[40] or antique, or other asset that maintains or increases its value over time.[41]

If the amount of loss before applying the dollar amount and 10 percent AGI limitation is less than $5,000, the individual may simply make a good faith estimate of the decrease in the FMV of the belongings, provided they maintain records describing the personal belongings that were affected and the method for estimating the loss.[42]

For larger losses, the replacement cost method may be used to determine the FMV of the personal belongings immediately before the hurricane. Individuals electing this safe harbor must apply the method to all personal belongings for which a casualty loss is claimed, with the exception of certain vehicles.[43] To apply this method, the taxpayer inventories each item of personal property lost, the age in years of that property and the current replacement cost of those items. Replacement cost for each item is multiplied by the applicable table percentage, which is based on the age in years of each damaged item. See Table 1.

TABLE 1
Personal Belongings Valuation Table[44]

Year	% of Replacement Cost to Use
1	90%
2	80%
3	70%
4	60%
5	50%
6	40%
7	30%
8	20%
9+	10%

Other Hurricane Harvey, Irma and Maria Relief Provisions

The Disaster Tax Relief and Airport and Airway Extension Act of 2017[45] provided other casualty and theft loss relief where the casualty or theft occurred to taxpayers living in certain areas affected by Hurricanes Harvey, Irma and Maria. When individuals who suffered an economic loss from these storms take an early distribution of up to $100,000 from a retirement plan, the 10 percent additional tax on the early distributions made on or after specified dates will be waived.[46] Similarly, penalties on 2016 federally declared disasters and 2017 qualified wildfire distributions will be waived. The dates, by disaster and source, are shown in Table 2.

Such distributions are still subject to regular income tax unless the taxpayer repays the distribution by making additional contributions to a retirement account within three years. Any unrepaid amount will be included in gross income by dividing the amount over a three-year period. If a taxpayer made a withdrawal from a retirement fund to purchase a home in the hurricane area and that contract was cancelled due to the hurricane, an individual may recontribute

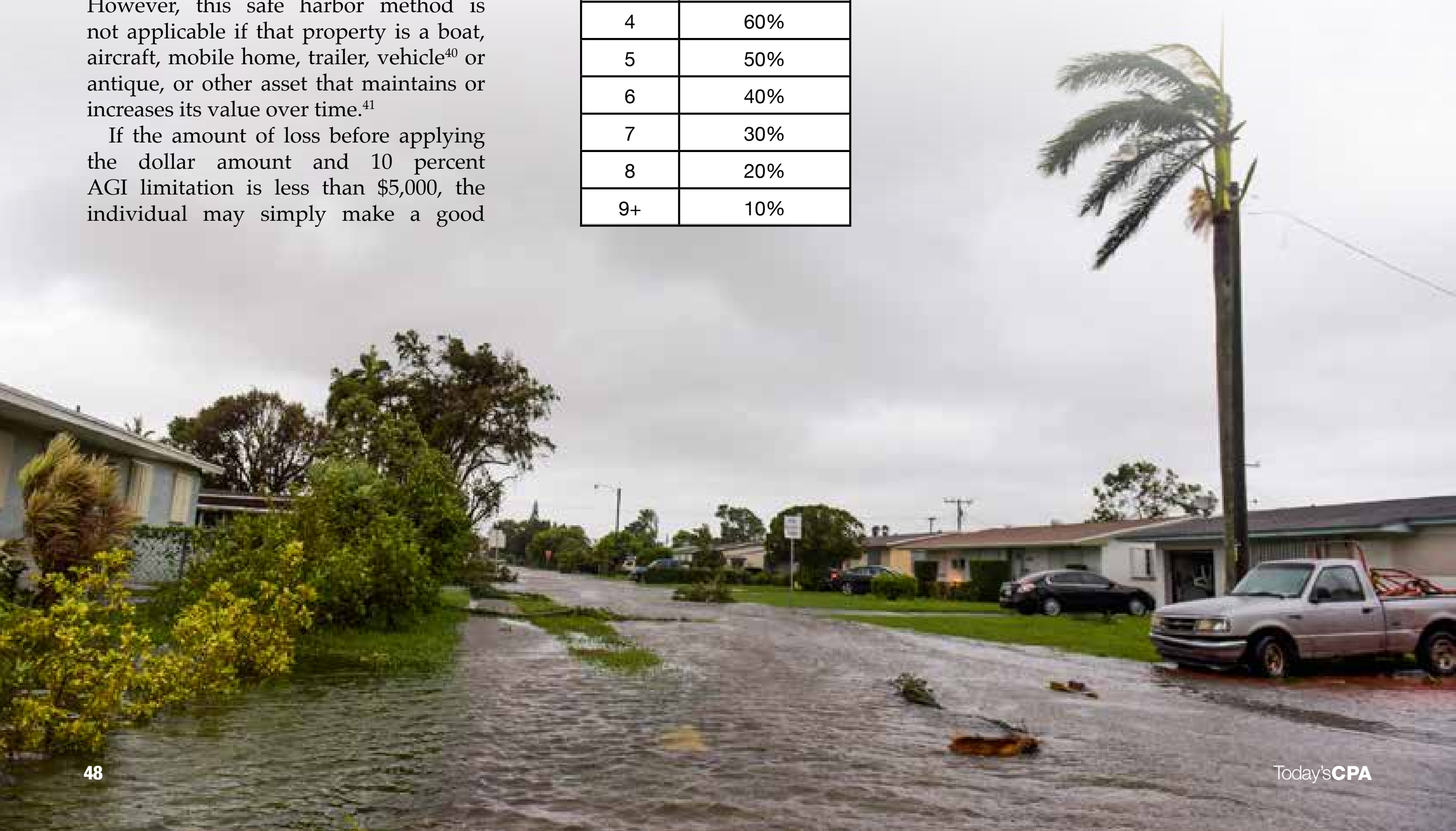

TABLE 2
Early Withdrawal Penalty Waiver Table

Casualty	Distribution Date On or After:	Distribution Date Before:	Cite
Hurricane Harvey	August 23, 2017	January 1, 2019	Pub. Law No.115-63, Sec. 502(a)(4)(A)
Hurricane Irma	September 4, 2017	January 1, 2019	
Hurricane Maria	September 16, 2017	January 1, 2019	
2016 Federally Declared Disasters	January 1, 2016	January 1, 2018	Pub. Law No.115-97, Sec. 11028(b)(1)(D)
Qualified Wildfires	October 8, 2017	January 1, 2019	Pub. Law No.115-123, Sec. 20102(a)(4)(A)

funds to the retirement plan without tax or penalty. The limit and repayment deadline for loans from retirement plans have also been extended. This favorable tax treatment was extended by the Tax Cuts and Jobs Act to include similar distributions made on or after January 1, 2016 and before January 1, 2018 for all victims in federally declared disaster areas whose principal place of abode was in such an area.

Additionally, employers who were not open for business because of the hurricanes are eligible for an employee retention tax credit in the amount of 40 percent of the qualified wages paid to employees while the business was closed, up to $6,000 per employee whose principal place of employment on specified dates was in a hurricane disaster zone. "Qualified wages" must have been paid or incurred on or after August 23, 2017, but before January 1, 2018. To qualify, the wages must have been paid during the period that began when the employee's principal place of employment became inoperable and ended when the business had resumed significant operations. These credits reduce the wages deduction and may be less effective if the taxpayer is subject to alternative minimum tax.[47]

Taxpayers in hurricane disaster areas may use the earned income from the immediately preceding years to determine the earned income tax credit and the child tax credit. Importantly, those in the hurricane disaster areas do ***not*** need to deduct 10 percent of AGI or itemize their deductions to take a hurricane casualty loss. This treatment is extended beyond the 2017 hurricanes. While the dates are confusing, effective after December 31, 2107 and before January 1, 2026, victims of 2016 disasters may add their net personal-use casualty losses from disaster areas to the standard deduction and use this casualty loss to reduce their alternative minimum taxable income. However, the increase from $100-per-casualty to $500-per-casualty is also extended to other casualties in federally declared disaster areas during the same time.[48]

How to Claim the Casualty Loss Deduction

Taxpayers report casualty gains and losses from casualties and thefts on Form 4684, Casualties and Thefts. Personal-use property still needs to be listed and Publication 584, Casualty, Disaster and Theft Loss Workbook (Personal-Use Property) is useful. Where 2017 losses are claimed on the 2016 return, a statement should be included with the 2016 original or amended return affirmatively making the election and listing the name and date of the disaster, as well as the city, county, state and zip code where the damaged property was located. This statement may be made on line 1 or 19 of Form 4684 or as an attachment. Beginning in 2018, the election will be made in Part I of Section D of Form 4684.

If a safe harbor method from Rev. Proc. 2018-8 is used, an affirmative written statement, along with the specific safe harbor method used, must be filed. Where the Cost Index Safe Harbor Method from Rev. Proc. 2018-9 is used, a statement and the number of the table used should be attached to Form 4684, Casualties and Thefts.

To revoke a prior election, a similar statement is required. That statement must include an affirmative revocation statement, the name and date of the disaster, as well as the address including the city, county, state and zip code where the damaged property was located and follow the instructions for the form.

2017 Legislative Changes Beginning 2016 and the New Safe Harbor Rules

Legislative changes in 2017 suspend personal casualty and theft losses deductions *except for those incurred in a federally declared disaster area,* beginning after December 31, 2017.[49] House fires from casualties such as lightning strikes will no longer qualify for tax relief. The government website www.FEMA.gov/Disaster posts federal declarations. In the past, major storms have generally been given such a declaration.

Knowing the Laws and Safe Harbors

The law regarding casualty losses has just changed rapidly in the face of many federally declared natural disasters creating billions of dollars' worth of damage. When claiming a casualty loss deduction, it is imperative that CPAs know the laws and safe harbors pertaining to specific applicable storms. This includes special provisions that allow for damages to be claimed, even if records that show property valuations are destroyed. Further, remember that beginning in 2018, deductions for casualty losses are limited to those in a federally declared disaster area.

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Please note that when registration is complete, a confirmation email will be sent and provide a hyperlink to access the quiz.

CPE Article: Safe Harbor Rules for Calculating Casualty Losses for Victims of Federally Declared Disaster Areas

By Valrie Chambers, Ph.D., CPA; Gerard H. Schreiber, Jr., CPA; and Brian Elzweig, JD, LL.M.

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 TSCPA 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 Tax Cuts and Jobs Act of 2017 eliminates the casualty loss tax deductions beginning in 2018 for which of the following:

A. Personal casualties not in a federally declared disaster area.
B. All personal casualty losses.
C. All casualties not in a federally declared disaster area.
D. Any casualty not reimbursable by insurance.

2. All of the following are safe harbor methods for computing casualty losses under Revenue Procedure 2018-8 except:

A. Estimated Repair Cost Safe Harbor Method
B. DeMinimis Safe Harbor Method
C. Insurance Safe Harbor Method
D. Sentimental Value Safe Harbor Method

3. Assuming a casualty qualifies for a deduction, what percent of AGI limitation for personal, itemized casualty losses is in effect after the Tax Cuts and Jobs Act of 2017?

A. 0%
B. 5%
C. 10%
D. 15%

4. A taxpayer wants to withdraw funds from a retirement plan to rebuild after a personal casualty loss in a federally declared disaster area. Which protection is available for such taxpayers?

A. They are allowed to withdraw up to $100,000 from a retirement plan without the 10 percent penalty that normally applies to early withdrawals.
B. They do not have to pay tax on the withdrawal if it is used and not replaced.
C. Their withdrawals are taxed at a favorable, long-term capital gain rate.
D. The tax on withdrawals is deferred for until they retire.

5. A taxpayer who was a victim of Hurricane Harvey lost a house and all basis records for that house in that hurricane/flood. How might the taxpayer document the amount of that loss?

A. The taxpayer loses the entire casualty loss, except to the extent that they can provide third party documentation of the amount of the actual loss sustained.
B. There is a Revenue Procedure that provides alternate casualty loss valuation tables, which may be used to determine a taxpayer's casualty loss.
C. The taxpayer may estimate the amount of the loss based on the expenditures that the IRS allows when calculating an offer in compromise for back taxes for someone of their income level.
D. The taxpayer may use the Hurricane Katrina casualty loss valuation tables.

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6. Lightning strikes a taxpayer's home, setting it on fire in a small, local thunderstorm. Which limitation most likely has the biggest effect on the amount of the deductible personal casualty loss?

A. No casualty loss is allowed for amount reimbursed by insurance.
B. Only amounts in excess of 10% of AGI are deductible.
C. There is a $100/incident floor.
D. No personal casualty loss is allowable unless it occurred in a federally declared disaster area.

7. For a personal casualty loss to be deductible, which of the following must a taxpayer do?

A. They must file an insurance claim for the casualty if they are insured.
B. They must restore or replace whatever property was damaged.
C. They must have a qualified appraisal after repairs are made.
D. They must attach receipts to the tax return.

8. Which of the following is true of a business casualty loss?

A. It is deductible whether or not it is in a federally declared disaster area.
B. Only the amount in excess of 10% of AGI is deductible.
C. It is only available if the taxpayer itemizes their deductions.
D. It is only deductible if the business is insured.

9. Victims in a federally declared disaster area may file a casualty loss claim on his/her tax return against which of the following years?

A. The return for the tax year in which the loss occurred only.
B. The return for the previous tax year only.
C. The return for either the tax year in which the loss occurred or the previous tax year.
D. The return for the tax year following the year in which it occurred.

10. When using the cost of repairs to estimate a casualty loss, which of the following may be considered when making the calculation?

A. Cleaning costs of a flooded house.
B. Appraisal fees.
C. Replacement cost of a damaged automobile.
D. Repairs made to a damaged roof.

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$323,675 gross. NW of San Antonio CPA firm. Write-up (12%), tax (37%), gov/nonprofit audits (51%), cash flow 65%, staff in place and owner to assist with transition. TXC1064

$199,000 gross. E. TX (near I-30) CPA firm. 27% tax, 27% consulting, 33% audits/reviews, 13% bkkpg/payroll, seller available for extended transition. TXN1447

$290,000 gross. E/SE Texas CPA firm. Primarily tax (70%), high-quality clientele, solid fee structure, turnkey opportunity. TXN1451

$900,000 gross. Dallas area tax consulting firm. Strong fees and cash flow over 70%. Quality client base of mostly mid-sized businesses; tenured staff member. TXN1461

$108,000 gross. Carthage tax firm. All individual tax work, loyal client base, knowledgeable staff person, location flexibility. TXN1470

$395,000 gross. Grayson Co. CPA firm. (68%) tax, (24%) accntng, (9%) consulting, staff in place, loyal client base, turnkey opportunity. TXN1471

$475,000 gross. SW Arlington CPA firm. (55%) tax, (32%) accntng, (11%) misc. consulting, loyal client base, staff in place, seller flexible with transition assistance. TXN1474

$66,000 gross. N. Dallas (portable) CPA firm. High-quality clients, primarily individuals and several businesses, revenues mostly from tax, solid fee structure. TXN1482

$210,000 gross. Grapevine CPA firm. 77% tax, 17% bkkpng, 6% reviews, cash flow over 55%, turnkey practice with high-quality client base. TXN1483

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

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$196,570 gross. West Houston CPA firm. Majority of services are ind. and bus. tax with some bkkpng/consulting. Good fee structure, staff in place, turnkey with owner available to assist with transition. TXS1207

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[1] Jeff Masters, Hurricane Maria Damage Estimate of $102 Billion Surpassed only by Katrina, Weather Underground, Nov. 22, 2017, https://www.wunderground.com/cat6/hurricane-maria-damages-102-billion-surpassed-only-katrina.
[2] Pub. Law No.115-63.
[3] Pub. Law No.115-97, 131 Stat. 2054.
[4] Pub. Law No. 115-123.
[5] However, losses from gradual deterioration, e.g. erosion, are not casualties. See *Matheson v. Comm.*, 2 USTC ¶830, 10AFTR 945, 54F.2d537 (CA-2, 1931), 1931 U.S. Appeals Lexis 3966.
[6] If spouses file separately, each spouse is subject to a $100/$500 floor for each casualty (Reg. §1.165-7(b)(4)(iii)) in addition to the 10% of AGI per year floor.
[7] Rev. Reg. §1.165-7(a)(2)(i).
[8] T.C. Summary Opinion 2010-174.
[9] See *Lamphere v. Commissioner*, 70 T.C. 391, 396 (1978), acq., 1978-2 C.B. 2; *Farber v. Commissioner*, 57 T.C. 714, 719 (1972), acq., 1972-2 C.B. 2.
[10] Costs of cleaning and repairs are not casualty losses, but those costs might be used to measure the decrease in FMV if the taxpayer actually made the repairs and they were necessary to bring the property back to its pre-casualty condition, providing the amount spent for repairs is not excessive and do not improve the property beyond its pre-casualty condition. See Reg. §1.165-7(a)(2).
[11] However, appraisal fees, photographs for documenting the casualty loss and similar costs may be deductible as an itemized deduction subject to the 2% of Adjusted Gross Income floor.
[12] Rev. Reg. §1.469-2(d)(2)(xi).
[13] IRC §1012 and Rev. Reg. §1.1012-1(a).
[14] IRC §1016(a)(1) and Rev. Reg §1.1016-2(a).
[15] IRC §1016.
[16] Rev. Reg. §1.165-1(c)(4).
[17] Internal Revenue Code (IRC) §165(h)(4)(E).
[18] IRC Sec. 139 provides for an exclusion from income for other relief payments, such as certain FEMA payments.
[19] Rev. Reg. §1.165-1(d)(2)(iii). Also see IRC Sec. 111 for the tax benefit rule, generally. IRS Publication 525, Worksheet 2, "Recovery of Itemized Deductions" is very useful in figuring taxable recovery.
[20] IRC §§162, 67 and 212 allow for the deduction of casualty losses on property held for profit. IRC §165(c)(3) allows for the deduction of casualty and theft losses on personal-use property, including casualty losses relating to hobbies (§183). Also see Regs. §1.165-8(d). For business properties, taxpayers must also consider repair regulations in computing the loss on business property.
[21] IRC §§67 and 165(c)(2).
[22] IRC §165(h)(1).
[23] IRC §165(h)(2).
[24] Reg. §1.165-7(a)).
[25] A federally declared disaster area is an area where the victims of a disaster are eligible for federal assistance under the Disaster Relief and Emergency Assistance Act (IRC §1033(h)). This term will also be used for determining whether involuntary conversion rules apply (IRC §1033(h); IRC §165(i)(5)), qualified disaster relief payments are excludable from gross income (IRC §139), certain NOL carrybacks apply (IRC §172) and deadlines may be postponed by the IRS (IRC §7508A). These areas are listed at www.fema.gov/diasters.
[26] IRC §165(i).
[27] See Rev. Proc. 2016-53.
[28] https://www.aicpa.org/content/dam/aicpa/.../tax/.../ssts-no.4-use-of-estimates.pdf.
[29] Id. §1.04.
[30] Rev. Proc. 2018-8, Introduction.
[31] Id. §7.
[32] Rev. Proc. 2018-8, §3.02.
[33] For the complete safe harbor treatment under Hurricanes Katrina, Rita and Wilma, see Rev. Proc. 2006-32.
[34] Rev. Proc. 2018-8, §4.01.
[35] Rev. Proc. 2018-8, §4.02.
[36] Rev. Proc. 2018-8, §5.01.
[37] Rev. Proc. 2018-8, §4.04.
[38] Rev. Proc. 2018-8, §4.05.
[39] Id.
[40] In this Rev. Proc., a vehicle is defined as "an automobile, motorcycle, motor home, recreational vehicle, sport utility vehicle, off-road vehicle, van, or truck." Rev. Proc. 2018-8, §5.02.
[41] Rev. Proc. 2018-8, §5.03. Individuals may determine pre-disaster values of boats, aircraft, mobile homes, trailers and other vehicles through established pricing sources as outlined in Rev. Rul. 2002-67, 2002-2 C.B. 873 or Publication 561, *Determining the Value of Donated Property.*
[42] Rev. Proc. 2018-8, §5.01.
[43] Rev. Proc. 2018-8, §5.02.
[44] Rev. Proc. 2018-8, §5. These are the same percentages used in the Katrina safe harbor rules, http://www.irs.gov/irb/2006-28_IRB/ar11.html.
[45] Pub. L. No. 115-63, (Sept. 29, 2017).
[46] Tax Cuts and Jobs Act of 2017 Sec. 11028(b).
[47] See Form 5884-A, *Credits for Affected Disaster Area Employees.*
[48] IRC §165(h), as amended by the Tax Cuts and Jobs Act (Act), P.L. 115-97, §11028(c)(1)(A).
[49] IRC §165(h), as amended by the Tax Cuts and Jobs Act (Act), P.L. 115-97, §11044.