Field of Study: Taxes

After busy season, preparers are now facing a greater than usual amount of extended tax returns. To complete those returns, they are looking in many cases for additional guidance from the IRS and/or technical corrections from Congress. Barbara Weltman, president of Big Ideas for Small Business, addresses a number of lingering 2018 tax issues, from the treatment of qualified improvement property to the deductibility of property taxes by someone with an office in the home.

Field of Study: Taxes

Since the sweeping changes to the Internal Revenue Code from the Tax Cuts and Jobs Act, the IRS continues to provide regulatory guidance on how enterprises should reflect the new provisions on their 2018 business tax returns. Edward Zollars, a partner in Thomas, Zollars & Lynch, Ltd. and a discussion leader for Kaplan Professional, reports on a number of business tax issues causing continued concern and what information you may still be required to obtain.

Field of Study: Auditing

While examining internal controls and financial statements is the responsibility of external auditors, internal auditing is an effective tool for keeping the enterprise performing at its highest level. As a result, internal auditors must be committed to delivering their message. We assembled a group of three high-level internal audit executives to address today’s challenges: Stephanie Johnson of JPMorgan Chase; David Lehmann of Protiviti; and Mark Martinelli of Synchrony.

Field of Study: Accounting

There is little doubt that derivative instruments can mitigate risks, particularly for those enterprises where uncertainty is undesirable. But many businesses often resist the use of derivatives, especially since hedge accounting has been a complex aspect of financial reporting. Dr. Ira Kawaller, the founder of Derivatives Litigation Services, focuses on why and how these instruments can aid in managing enterprise risk and provides an update of the latest hedge accounting rules.
CPE Requirements

When properly administered, the CPA Report (CPAR) educational program meets the requirements for group live and self-study participation as defined in the Statement for Standards in CPE Reporting.

Note: CPE requirements vary from state to state. State boards of accountancy have final authority on the acceptance of individual courses for CPE credit. CPAs should contact their state board regarding specific CPE requirements.

Self-Study Format

SELF-STUDY SUBSCRIBER NOTICE:

The online components of the CPAR self-study program are delivered via Kaplan Financial Education, powered by SmartPros, enhanced by our e-Learning Player (eLP). What does this mean to you and your students? In brief, a better self-study learning experience – a more intuitive learning environment and a higher level of user compatibility as the eLP is based on today’s most widely accepted media delivery platforms and is corporate firewall friendly.

The eLP requires Adobe Flash Player 8 or higher (formerly Macromedia Flash Player) – a free download if you don’t already have it.

Please note: This issue of CPA Report is scheduled to be available on the CPAR Self-Study PEC on May 26, 2019.

When taking a CPA Report segment on a self-study basis, an individual earns CPE credit by doing the following:

1. Viewing the video (approximately 30–35 minutes).
2. Completing the Required Reading (approximately 25–30 minutes).
3. Completing the following steps online (approximately 35–45 minutes):

Steps for Using the Self-Study Professional Education Center

To access the Self-Study Professional Education Center to take quizzes and check credits, follow these steps:

Step 1: How to Create and Access Your Account

1. Visit http://education.smartpros.com/cpareportss
   Tip: Add this page to your Favorites for easy access.

2. Click on “New User?” to create an account.* We recommend to use your e-mail address as your username.
   * If you have already created an account at the CPAR Self-Study Professional Education Center, enter your username and password, and click on “LOGON.”

3. You are logged into Your Account.
   From Your Account, you can view your CPE credits, take quizzes, track external CPE credits and more.
Step 2: How to Take a Quiz

1. Click on “Video Quiz Catalog” on the left-hand side of Your Account in the Self-Study Professional Education Center.
   
   **Note:** You must already be logged in for this link to be available to you. See Step 1 if you are not already logged in.

2. Enter your firm code.
   - Your firm code is on your CPAR Video mailing label, and may also be available from your CPE administrator.

3. Select the Subject Area for the course you’re taking. (Refer to the Subscriber Guide or Summary Page.)

4. Click on the course for which you would like to receive self-study credit.

5. Click “enroll in course” on the course description page.

6. You will now be at Your Account.
   - The course you just selected will launch automatically, and it will also be available in the Enrolled Courses section of My Courses.

7. To proceed, watch the video (offline), then online follow these steps in order and take the Final Examination:
   - 1. Mid-Review Questions
   - 2. Final Review Questions
   - 3. Required Reading
   - 4. Required Reading Questions
   - 5. Other Resources
   - 6. Discussion Issues
   - 7. Final Exam
Step 3: How to View and Print a Course Certificate

Once an online quiz is completed, and you have scored 70% or better, you can view and print completion certificates from Your Account.

- In the Completed Courses section of Your Account, click on “View Certificate” next to the title of the course for which you would like to view the certificate of completion.
- Click “View for Print.”

Step 4: How to Check and Track CPE Credits

From Your Account in the Self-Study Professional Education Center:

1. Credit Hours Report
   - Click on the “My Courses” tab. Click on the “Credit Hours Report” tab. Select your start and end date and click “submit.” From here, you can print your report for CPE reporting.

2. To track CPE credits earned from external sources (other than CPAR Video):
   - Use the External Course Journal. Click “Add course to journal” to begin tracking an external course.

If you need more information or have any questions, please contact Customer Service at customerservice@smartpros.com or 914-517-1177.

Kaplan Financial Education, Powered by SmartPros, is registered with the National Association of State Boards of Accountancy (NASBA) as a sponsor of continuing professional education on the National Registry of CPE Sponsors. State boards of accountancy have final authority on the acceptance of individual courses for CPE credit. Complaints regarding registered sponsors may be submitted to the National Registry of CPE Sponsors through its website: https://www.nasbaregistry.org/.
Group Live Format

When taking a CPA Report segment on a group live basis, individuals earn CPE credits when they (or their organization) do the following:

1. Select discussion leaders who have the appropriate education and/or experience both to teach the segment subject and conduct the subsequent group discussion.
2. Have each discussion leader review the video segment and the written materials in the Subscribers Guide prior to the presentation of the segment.
3. Make sure that each discussion leader certifies the attendance at his/her discussion group by signing and dating the Group Live Attendance Form.
4. (Individuals) View the video segment (approximately 30 minutes).
5. (Individuals) Discuss the segment materials as they relate to his/her own work and/or organization (approximately 20 minutes).
6. (Individuals) Evaluate the discussion leader using the criteria listed on the Evaluation Form.
7. Check with your State Board of Accountancy for specific details, including group live sponsorship registration requirements.

How to Implement CPA Report

The following information will help you plan and implement CPA Report within your firm:

1. Each month, by e-mail, you may receive a CPA Report Summary Page in advance of the video program notifying you of the upcoming Continuing Professional Education topics that will be covered (Note: CPAR is not issued in March).
2. The CPAR video and Subscribers Guide will arrive 11 months of the year. If you do not have a standard day and time each month designated as CPE day, issue a memo with the date of your upcoming seminar. (If attendance is not required, please provide plenty of advance notice for optimum participation).
3. Select the topic(s) you wish to cover in your session when the CPAR Summary Page or the actual program arrives.
4. It is best for a firm to have its CPE classes on a regular and consistent basis, so it is easy for the staff to remember when scheduling clients. For example, on the second and fourth Mondays of the month, on the 10th of the month, etc.
5. You may wish to provide each group live attendee a “Certificate of Completion” noting the hours earned and the topic areas.
6. Always check with your State Board of Accountancy for specific details, including group live sponsorship registration requirements.

Note: CPE requirements vary from state to state. State boards of accountancy have final authority on the acceptance of individual courses for CPE credit. CPAs should contact their state board regarding specific CPE requirements.

If you need more information or have any questions, please contact Customer Service at customerservice@smartpros.com or 914-517-1177.
Segment 1
1. After April 15th: Making Time for Extended Returns

Learning Objectives: Upon successful completion of this segment, you should be able to:

- Identify the difficulties that preparers experienced in filing 2018 tax returns;
- Distinguish between the property tax paid by condominium owners from the taxes paid by cooperative shareholders;
- Explain the benefits of the safe harbor approach for newly purchased vehicles in 2018; and
- Define what is meant by a conservation easement.

Segment Overview: After busy season, preparers are now facing a greater than usual amount of extended tax returns. To complete those returns, they are looking in many cases for additional guidance from the IRS and/or technical corrections from Congress. Barbara Weltman, president of Big Ideas for Small Business, addresses a number of lingering 2018 tax issues, from the treatment of qualified improvement property to the deductibility of property taxes by someone with an office in the home.

Field of Study: Taxes

Expiration Date: July 7, 2020

Course Level: Update

Course Prerequisites: Work experience in tax planning or tax compliance, or an introductory course in taxation

Advance Preparation: None

Recommended Accreditation:
- 1 hour group live
- 2 hours self-study

Required Reading (Self-Study):

- “Making Time for Extended Returns: After April 15th”
  By Ed Zollars, CPA, of Kaplan Professional
  Excerpted with permission from Current Federal Tax Developments
  For complete report, go to: www.currentfederaltaxdevelopments.com
  See page 1–11.

Video Transcript: See page 1–18.

Running Time: 38 minutes
Outline

I. Filing Challenges and Technical Corrections
A. Difficulties with 2018 Tax Preparation
   i. Late release of IRS regulations
   ii. Unfamiliarity with new Code provisions
   iii. Constant updating of software
B. Preliminary 2018 Filing Statistics
   i. Fewer electronically-prepared returns (not counting extensions)
   ii. More returns on extension (similar to 1987)
   iii. Or hoping for 15-year treatment for qualified improvement property (QIP)
C. Owners of Co-Op Apartments
   i. Deduct their share of property taxes under IRC sec. 216
      ▪ Instead of sec. 164
   ii. Yes, it was congressional intent, but not in the Tax Cuts and Jobs Act
   iii. May deduct more than $10,000 in taxes without a technical correction
D. Besides Technical Corrections from Congress, Still Need IRS Guidance on
   i. Tax treatment of unclaimed 401(k) accounts
   ii. TCJA: multinational taxes and qualified business income (199A)
E. Blame for Smaller Refunds?
   i. Individuals forget they had larger paychecks during the year
   ii. Preparer’s year-end planning software couldn’t anticipate final IRS guidance

II. Deductions and Taxability of Income
A. No Final News Yet about 2018 Filers
   i. Fewer charitable deductions?: people took standard deduction
   ii. Impact of SALT cap?: muted by AMT exemption and rate reduction
B. Based on $10,000 SALT Cap
   i. Good news: you may want home office deduction on Form 8829
C. If You Are Subject to $10,000 SALT Cap
   i. Good news: you may want home office deduction on Form 8829
   ii. Bad news: a portion of your state tax refund could be treated as income
D. Awards for Credit Card Purchases and Travel Rewards
   i. IRS Announcement 2002-18: considered nontaxable rebates
   ii. But cash bonuses for opening an account or referring a friend are taxable
III. Issues Surrounding Marriage Dissolution

A. New Rules for Alimony after 12/31/2018
   i. Alimony is not deductible by payor ex-spouse
   ii. Alimony is not includible in income for recipient ex-spouse
   iii. For agreements before 1/1/2019: no tax change

B. Transfers of Property in Cessation of Marriage
   i. Tax-free under IRC sec. 1041
   ii. If occurring within 6 years of cessation of marriage

C. IRS PLR 201901003: Sec. 1041 Transfer
   i. Six years after marriage, one ex-spouse finally transfers jointly-owned property to other
   ii. Good news: transfer is tax-free, since it was based on divorce decree
   iii. Bad news: recipient spouse only gets carryover basis

IV. Tax Treatment of Newly Purchased Vehicles

A. Newly-Purchased Vehicles in 2018
   i. 100% bonus depreciation, with first-year limit of $8000
   ii. Example: $50,000 car would provide $18,000 first-year deduction
   iii. Remaining $32,000 basis: start recovering in 2024 at $5,760/year

   i. Bonus depreciation: additional first-year allowance of $8,000
   ii. Applicable optional depreciation table: Table A-1 in Appendix A of Pub 946

C. Safe Harbor for $60,000 Car Purchased in 2018
   i. 2018: deduct $18,000, based on Rev. Proc. 2018-25
   ii. 2019: deduct $13,440, based 32% x $42,000

D. Safe Harbor Method Does NOT Apply If You
   i. Elect to apply sec. 179
   ii. Elect out of bonus depreciation
### V. Research Deductions and Credits

A. Under IRC Sec. 174, Research Costs Can Be
   i. Deducted in full
   ii. Amortized over at least 60 months
   iii. Amortized over 10-year period
   iv. Starting 2022: amortize U.S. research over 5 years

B. Research Credit, Instead of a Deduction
   i. Bad news: must be taken to uncover technical information
   ii. Good news: can be used to offset employer’s share FICA taxes

C. IRS Dirty Dozen Tax Scams: IR-2018-49
   i. Don’t include nonqualified activities in the research credit!

### VI. Conservation Easements

A. Under IRC Sec. 170(h), Easement for Conservation Must Be in Perpetuity and Must
   i. Preserve land for public recreation
   ii. Protect natural habitat
   iii. Preserve open space, or
   iv. Preserve historically important structure

B. IRS Scrutiny of Conservation Easements
   i. Designated as listed transactions (Notice 2017-10)
   ii. Subject of a “compliance campaign”
   iii. Particularly: syndicated deals with huge ratios

   “Don’t forget: where the IRS has been successful in challenging large deductions for conservation easements, it means more revenue for the government.”

   — Barbara Weltman

   i. Partnership donated land, but “reserved” some building areas
   ii. IRS and Tax Court: no deduction since conserved land could be taken back

D. Latest Conservation Easement Battles
   i. U.S. Justice Dept. targets $2 billion in charitable contribution deductions
   ii. Proposed legislation – Charitable Conservation Easement Property Integrity Act – would limit deductions

   i. Donated home to charity for demolition and reuse of materials
   ii. IRS and court: no deduction for deconstruction
   iii. Court: also lack of qualified appraisal

F. Theodore Rolfs (CA-7, 2012)
   i. Benefit from demolition outweighs any charitable contribution
   ii. You must have a good appraisal to claim a deduction
Group Live Option

Instructions for Segment

For additional information concerning CPE requirements, see page vi of this guide.

- As the Discussion Leader, you should introduce this video segment with words similar to the following:
  “In this segment, Barbara Weltman addresses a number of lingering 2018 tax issues, from the treatment of qualified improvement property to the deductibility of property taxes by someone with an office in the home.”
- Show Segment 1. The transcript of this video starts on page 1–18 of this guide.
- After playing the video, use the questions provided or ones you have developed to generate discussion. The answers to our discussion questions are on pages 1–7 and 1–8. Additional objective questions are on pages 1–9 and 1–10.
- After the discussion, complete the evaluation form on page A–1.

Discussion Questions

1. After April 15th: Making Time for Extended Returns

You may want to assign these discussion questions to individual participants before viewing the video segment.

1. Barbara Weltman notes several reactions from preparing 2018 tax returns: more clients than ever are extending their returns, and many clients expressed surprise/dismay about the extent to which they were under-withheld compared to prior years. To what extent did you experience similar, or contrasting, client reactions during the busy season? How did you explain to clients about the late changes in regulations from the IRS?

2. Bad news: many clients, such as restaurant owners, were surprised by the fact that they could not write-off their qualified improvement property. Good news: many owners of co-op apartments were surprised by the fact that they could deduct their entire property tax assessment, even in excess of $10,000. To what extent did you experience similar client reactions during busy season? How did you explain to clients about the need for Congress to enact technical corrections legislation?

3. Because fewer individuals are itemizing their deductions, fewer individuals are listing (and are benefiting from) their charitable contributions. From your experience and observations, what impact (if any) do you believe that the lack of an itemized deduction has had on your clients’ charitable generosity – either in total or in terms of where they are contributing?
4. Barbara Weltman relates the tale of some taxpayers who were surprised to have received 1099-MISC forms from their credit card issuers and from their frequent flier programs. To what extent did your clients receive “bonus” payments for opening an account or for referring a friend? How did you advise them to handle the payments? To what extent are your clients interested in contesting the taxability of the payments they received?

5. Once again, there is an update to the annual tax rates for vehicles allowances as well as a new depreciation safe harbor for vehicles purchased in 2018. And once again, Barbura Weltman reminds viewers of the necessity for maintaining records on usage as well as cost. At what point do you typically find out about your clients’ vehicle purchases? About their annual vehicle usage? Is there anything that you can do to assist them, tax-wise, when you become aware of their existing purchases and usage?

6. According to Barbara Weltman, the IRS will launch compliance “campaigns” in a number of new areas this year – where there are potential abuses taking place and where the Service feels it can “make money.” To what extent do your clients have “investments” in syndicated conservation easements? What impact could an IRS audit have on your organization and its work processes?

7. Two recent cases highlight what happens when an individual takes a deduction for a charitable contribution after a building has been “deconstructed.” To what extent are your clients interested in potential deductions from property that has been torn down and/or replaced? What type of advice are you likely to give to clients who are pursuing these charitable contributions?
1. Suggested Answers to Discussion Questions

1. After April 15th: Making Time for Extended Returns

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   - Participant response is based on your practice and its structure, on your clients – their activities, their risk tolerance, and their filing habits – as well as on your perspective and experience.

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Suggested Answers to Discussion Questions (continued)

6. According to Barbara Weltman, the IRS will launch compliance “campaigns” in a number of new areas this year – where there are potential abuses taking place and where the Service feels it can “make money.” To what extent do your clients have “investments” in syndicated conservation easements? What impact could an IRS audit have on your organization and its work processes?
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   - Participant response is based on your practice and its structure, on your clients – their activities, their risk tolerance, and their filing habits – as well as on your perspective and experience.
Objective Questions

1. After April 15th: Making Time for Extended Returns

You may want to use these objective questions to test knowledge and/or to generate further discussion; **these questions are only for group live purposes.** Most of these questions are based on the video segment; **a few may be based on the required reading for self-study** that starts on page 1-11.

1. Taxpayers have experienced all of the following difficulties with preparation of their 2018 returns EXCEPT:
   a) the issuance of a complete set of new forms.
   b) the late release of IRS regulations.
   c) the unfamiliarity with new Code provisions.
   d) the constant updating of software.

2. According to Congress, owners of cooperative apartments:
   a) are specifically excluded from the SALT cap limits of the Tax Cut and Jobs Act (TCJA).
   b) must file extensions for their 2018 returns.
   c) are technically barred from deducting more than $10,000 in property taxes.
   d) are allowed to deduct property taxes in excess of SALT cap limits if they file certain forms with their returns.

3. Which of the following owners are subject to SALT tax limits?
   a) cooperative apartments only
   b) condominium owners only
   c) possibly cooperative apartments and definitely condominium owners
   d) neither cooperative apartments nor condominium owners

4. As a result of the TCJA, many taxpayers have received refunds in amounts _______ prior years.
   a) greater than
   b) less than
   c) roughly the same as
   d) IRS statistics cannot make this determination.

5. The lack of correlation between taxpayers who received refunds in 2018 and those whose SALT deduction was capped at $10,000 can be explained by the fact that:
   a) marginal rates were reduced by the TCJA.
   b) more people took charitable deductions.
   c) more people were subject to and paid the AMT.
   d) taxpayers no longer have to declare any portion of their state tax refunds in income.

6. Which of the following credit card awards are taxable?
   a) frequent flyer miles
   b) credit cards awards for purchases
   c) cash bonuses for opening an account
   d) All of the above are taxable.

7. Under the rules related to newly purchased vehicles in 2018:
   a) taxpayers can receive 50% bonus depreciation.
   b) taxpayers can opt out of the bonus depreciation rules created.
   c) taxpayers are subject to the bonus depreciation rules even if they elect to use section 179 rules.
   d) first year bonus depreciation is capped at $10,000.

8. Conservation easements:
   a) may be made even for non-conservation purposes in some limited instances.
   b) need not be in perpetuity.
   c) are being closely monitored by the IRS.
   d) cannot be created if they exceed ratios of $3 in deductions for every $1 invested.
9. Expenses related to a taxpayer’s use of a portion of their home for business:
   a) are deductible.
   b) are never deductible.
   c) are deductible up to $10,000.
   d) are deductible only if they relate to interest or taxes.

10. Current guidelines related to charitable donations provide that:
    a) taxpayers can make a donation of less than their entire interest in a property.
    b) donations greater than $250 require a written appraisal.
    c) taxpayers may receive a collateral benefit from a donation.
    d) there can be no quid pro quo associated with a donation.
Self-Study Option

Instructions for Segment

When taking a CPA Report segment on a self-study basis, an individual earns CPE credit by doing the following:

1. Viewing the video (approximately 30–35 minutes). The transcript of this video starts on page 1–18 of this guide.
2. Completing the Required Reading (approximately 25–30 minutes). The Required Reading for this segment starts below.
3. Completing the online steps (approximately 35–45 minutes). Please see pages iii to v at the beginning of this guide for instructions on completing these steps.

Required Reading (Self-Study)

MAKING TIME FOR EXTENDED RETURNS: AFTER APRIL 15th

By Ed Zollars, CPA, of Kaplan Professional
Excerpted with permission from Current Federal Tax Developments
For complete report, go to: www.currentfederaltaxdevelopments.com

Home Office and SALT Cap: PMTA 2019-001

In a Program Manager Technical Advice that must be parsed carefully (PMTA 2019-001), the IRS discusses the interplay between the office in home deduction under IRC §280A and the $10,000 cap on state and local taxes under IRC §164(b) added by the Tax Cuts and Jobs Act (TCJA). If the reader is not careful, he/she may jump to a very taxpayer unfriendly conclusion.

The PMTA comes to the following conclusion that may alarm readers at first:

If a taxpayer’s total individual state and local taxes meet or exceed the $10,000 limitation of §164(b)(6), or if the taxpayer chooses to take the standard deduction instead of itemizing deductions, none of the taxpayer’s state and local taxes relating to taxpayer’s business use of the home are included as expenses under §280A(b). If a taxpayer’s total individual state and local taxes do not meet or exceed the $10,000 limitation of §164(b)(6), and the taxpayer does not opt to take the standard deduction in lieu of itemized deductions, then the taxpayer can include as expenses under §280A(b) the business portion of the state and local taxes up to the difference between the limitation under §164(b)(6) and the amount of individual state and local taxes that the taxpayer actually deducted under §164.

The first sentence may suggest to those that don’t read carefully that a taxpayer could never get a deduction for real estate taxes allocable to the home office if he/she is already deducting over $10,000 in state and
local taxes. But the conclusion paragraph has a footnote reference at the end of that first sentence. The footnote reads:

Expenses relating to the taxpayer’s exclusive use of a portion of the taxpayer’s home for business purposes could still be deductible under a different exception to the general disallowance in §280A(a), for example, under §280A(c), but such deductions would be subject to the specific limitations in that exception.

IRC §280A(a) generally prevents taxpayers from deducting as business expenses any deduction which is incurred with respect to property used by the taxpayer as a residence during the year. However, the rest of IRC §280A contains various exceptions to this prohibition, as well as conditions that must be met to claim an office in home deduction.

The first exception, found at IRC §280A(b), provides the following special rule for items that would otherwise be deductible on the taxpayer’s return:

(b) Exception for interest, taxes, casualty losses, etc.

Subsection (a) shall not apply to any deduction allowable to the taxpayer without regard to its connection with his trade or business (or with his income-producing activity).

The PMTA explains the purpose behind this initial exception:

Section 280A(b) excepts from §280A(a) deductions allowable to the taxpayer without regard to the deduction’s connection with the taxpayer’s trade, business, or income-producing activity (i.e., mortgage interest, certain taxes, certain casualty losses that are allowable to individuals under other provisions of the Internal Revenue Code). Section 280A(b) is essentially a parity provision that prevents §280A(a) from limiting home expenses that would otherwise be allowable to individuals who are not using part of their home for trade, business, or other income-producing activity.

Deductions that cannot fit within IRC §280A(b)’s exception may still be allowed pursuant to the rules of IRC §280A(c). But §280A(c) imposes limits on the deductions that work to prevent such expenses (other than those the taxpayer would have qualified to deduct even without a home office) to no more than the income from the trade or business or rental.

Gross income from trade, business or rental
Minus: Deductions identified under §280A(b)
Minus: Deductions not incurred with residence (e.g., advertising, office supplies)
Minus: Gross income from which taxpayer can deduct §280A(c) expenses.

The PMTA gives the following explanation of how the limit under §280A(c) is computed:

The PMTA explains how the $10,000 cap interacts with these provisions:

Because the limitation under §164(b)(6) is calculated by combining the taxpayer’s state and local taxes, a taxpayer using a portion of the taxpayer’s residence for an income-producing purpose must first calculate the percentage of the business use of the home and then apply that percentage to the total amount of state and local taxes paid in connection with the ownership of that home to determine the portion of the state and local taxes attributable to the business use of the home and the portion attributable to the individual use of the home. Once that determination is made, the taxpayer combines the individual use portion with the taxpayer’s other individual state and local taxes paid (income taxes or sales taxes, personal property taxes, war profits, excess profits taxes, and other real property taxes) to determine the taxpayer’s total individual state and local taxes. If that amount meets or exceeds the $10,000 limitation under §164(b)(6), then the
taxpayer does not have any additional taxes that would be deductible under §164(b)(6). In that case, the entire business portion of the state and local taxes would be considered a §280A(c) expense subject to the gross income limitation under §280A(c)(5). Similarly, if a taxpayer opts to take the standard deduction in lieu of itemizing deductions, then the taxpayer is not entitled to any deduction under §164(b)(6), and the entire business portion of the state and local taxes would be considered a §280A(c) expense subject to the gross income limitation under §280A(c)(5).

Taxpayers with state and local taxes in excess of the $10,000 limit will be forced to treat the real estate taxes allocable to home office as a §280A(c) limited expense—the amount can be deducted, along with other §280A(c) expenses, to the extent there is sufficient income from the trade, business or rental. If not, the unused portion of the deduction is carried forward to be potentially used in future years when the taxpayer has income from the trade, business or rental.

The PMTA contains the following examples of applying its holdings:

**Example 1:** Taxpayer has a home that he rents for 1/3 of the year. Taxpayer’s real estate taxes on the home are $12,000. Taxpayer also pays $5,000 in state and local income taxes. The real estate taxes are allocated $8,000 to the individual use of the home and $4,000 to the rental use of the home. Taxpayer’s total individual state and local taxes paid equal $13,000 (i.e., $8,000 individual real estate taxes plus $5,000 state and local income taxes). Under §164(b)(6), Taxpayer’s individual itemized deduction for state and local taxes is limited to $10,000. Because Taxpayer’s actual individual state and local taxes exceeds to the $10,000 limit under §164(b)(6), Taxpayer’s $4,000 of real estate taxes attributable to the rental use of the taxpayer’s home are expenses under §280A(c) and are subject to the gross income limitation under §280A(c)(5). None of Taxpayer’s real estate taxes attributable to the rental use of the Taxpayer’s home are expenses under §280A(b).

**Example 2:** The facts are the same as Example 1, except that Taxpayer rents the home for 2/3 of the year. In this example, the real estate taxes are allocated $4,000 to the individual use of the home and $8,000 to the rental use of the home. Taxpayer also paid $12,000 in mortgage interest on the home but had no other itemized deductions. Therefore, Taxpayer’s total individual state and local taxes equal $9,000 ($4,000 individual real estate taxes plus $5,000 state and local income taxes) and Taxpayer’s total individual itemized deductions equal $13,000 ($9,000 in state and local taxes plus $4,000 in mortgage interest (1/3 of the total mortgage interest paid)). Taxpayer’s itemized deductions exceed the standard deduction amount of $12,000, so Taxpayer chooses to itemize his deductions. Taxpayer’s total individual state and local taxes do not meet or exceed the $10,000 limitation in §164(b)(6). If Taxpayer had not rented his home, Taxpayer would have been able to deduct an additional $1,000 of the real estate taxes, which are currently attributable to the business use of the home, as individual state and local taxes under §164(b)(6). As such, Taxpayer can include as a §280A(b) expense the $1,000 (the difference between the $10,000 limitation under §164(b)(6) and $9,000 (Taxpayer’s total individual state and local taxes)), and such amount will not be subject to the gross income limitation of §280A(c)(5). The rest of Taxpayer’s real estate taxes attributable to the rental use of the home ($7,000) are §280A(c) expenses and are subject to the gross income limitation under §280A(c)(5).

**Example 3:** The facts are the same as Example 2, except that Taxpayer did not pay any mortgage interest on the home. As such, Taxpayer had a total of $9,000 in individual itemized deductions and opted to take the standard deduction of $12,000 under §63(c) instead of itemizing his deductions. Because Taxpayer opted to take the standard deduction in lieu of itemized deductions, there is no amount of state and
local taxes that would have otherwise been allowable to Taxpayer under § 164 but for the rental use of the home. As such, all of the real estate taxes attributable to the rental use of the home are §280A(c) expenses and are subject to the gross income limitation of §280A(c)(5).

The PMTA ends by noting that similar logic would apply to other deductions subject to various limitations or disallowances, including home mortgage interest and casualty losses. Thus interest on the mortgage balance in excess of the acquisition debt limitations would become §280A(c) limited expenses when claiming a home office deduction.

Charitable Deduction for Deconstruction

A district court granted summary judgment for the IRS on its denial of a married couple's charitable donation of a house, and the personal property in it, to a charitable organization that provides job training to disadvantaged individuals through the salvaging of building materials from properties because the taxpayers failed to validly convey an interest in the house to the organization and did not include with their tax return a qualified appraisal of the donated property. However, the court allowed the couple's charitable deduction for cash payments to the organization, finding that the payments were not quid pro quo payments but donations to support the organization's charitable mission. Mann v. U.S., 2019 PTC 46 (D. Md. 2019).

Background: Lawrence and Linda Mann purchased real property, including a colonial-style house in Bethesda, Maryland in 2011. The Manns later discovered that the house had a wet basement and, given that they also did not consider the layout to be suitable to their needs, they decided to have the house demolished and to build a new one on the property.

The Manns hired a contractor to demolish the house and build a new residence on the property. Prior to the demolition, the Manns contacted Second Chance about donating the house. Second Chance is a Code Sec. 501(c)(3) organization that engages in property "deconstruction," the salvaging of building materials, fixtures, and furniture from properties. Second Chance's deconstruction employees are disadvantaged individuals in need of workforce training. The organization provides these employees with general life skills training and specific work skills through its deconstruction projects. It also sells some salvaged items at its retail store. Second Chance does not perform demolition services, although its deconstruction efforts at times result in destruction of parts of the subject property, either because disassembly requires some destruction or because destruction is useful in training employees. To defray its costs, donors are asked to supplement their property donations with cash donations.

In 2011, the Manns signed a contract conveying to Second Chance all of their rights, title, and interest in the improvements, the building, and the fixtures on the property. The agreement was not recorded in the county land records. By a separate agreement, Mrs. Mann also conveyed various pieces of furniture and other personal property in and around the house.

Regarding the tax implications of their donation, Second Chance told the Manns that donors could claim a deduction for all material that "crosses the threshold" of the Second Chance warehouse. Second Chance said it expected the deconstruction to yield items with a fair market value of $150,000 at a minimum, which would translate to a tax savings for the Manns of approximately $45,000. The Manns also made cash donations of $10,000 in 2011 and $1,500 in 2012. In response to both contributions, Second Chance sent a letter stating that the Manns received nothing of value in exchange for the donation and that the entire amount was tax deductible.

Second Chance completed the deconstruction in 2012. It informed the Manns that they had not been able to
extract as much salvage material from the house as they had hoped. Second Chance did not keep a manifest or other record of exactly what materials were salvaged. Second Chance incurred approximately $13,100 in expenses in deconstructing the house. The deconstruction did not reduce the cost to the Manns of the later demolition of the house.

The Manns commissioned three appraisals in connection with their donations, two for the house and one for the personal property inside it. Appraisal A valued the house at $675,000 based on consideration of the highest and best use of the house, which the appraiser determined was keeping it intact and moving it to another site for use as a residence. Appraisal B established the donation value of the deconstructed house at approximately $313,000. This figure was derived by calculating the cost to construct the house with new materials, then subtracting out labor and administrative costs, and then accounting for depreciation, an approach used because of the lack of a well-established second hand market for all building materials used in the construction of the house. The personal property appraisal valued the personal property at approximately $24,200.

On their 2011 tax return, the Manns claimed charitable donations of $675,000 for the value of the house, $24,200 for the personal property, and $10,000 for the cash donation. They claimed the $1,500 donation to Second Chance on their 2012 return. The IRS disallowed all of these deductions and denied the Manns' appeal of the additional tax assessments in 2015. The Manns then paid the taxes and sued for refunds in a district court. In 2016, in an effort to avoid litigating the 2011 deductions, the Manns filed an amended 2011 tax return, adjusting the deduction for the house donation from $675,000 to $313,000. In 2017, the Manns filed suit seeking a determination that their original claimed deductions were valid and a full refund of the additional taxes paid in 2011 and 2012 as a result of the disallowance of the deductions.

Analysis: Under Code Sec. 170(a)(1), taxpayers are generally allowed to deduct a charitable contribution paid within a tax year if the donation can be substantiated in accordance with the regulations. Charitable deductions are generally not allowed for donations consisting of less than the taxpayer's entire interest in the donated property. Whether a donation is of an entire interest or a partial one depends on the taxpayer's property rights under state law. Under Code Sec. 170(f)(11), contributions for which a deduction of more than $5,000 is claimed must be accompanied by a qualified appraisal, which must include the method of, and specific basis for, the valuation. A charitable donation cannot be made with the expectation of any quid pro quo.

The IRS argued that the Manns could not deduct either the $675,000 fair market value or the amended $313,000 deconstructed value of the house because they donated only a partial interest in the property. The IRS also contended that the Manns could not deduct the donation of their personal property inside the house because the appraisal was deficient in several respects. As for the cash donations to Second Chance, the IRS asserted that they were nondeductible as quid pro quo for Second Chance's deconstruction services. According to the IRS, the Manns received the specific benefit of the deconstruction services in exchange for the cash donation and it noted that such services are available from for-profit businesses.

The district court granted summary judgment for the IRS as to the house and personal property deductions. The Manns raised no opposition on the issue of the personal property deductions, so the court concluded that they effectively abandoned their claim for that deduction.

The court found that under Maryland law, ownership of improvements to land follows title to the land; thus, for someone other than the record landowner to own the improvements, there must be a recorded
deed showing the transfer of title to the improvements. In other words, record ownership, not contractual ownership, demonstrates ownership of improvements in Maryland, according to the court. The court noted that the Manns tried to convey their interest in the house through a contract with Second Chance but never recorded the transaction, and therefore concluded that the house had not been properly severed from the land and transferred. In the court's view, the Manns' donation was comparable to the granting of a license to access and use the house for salvage and training purposes.

The court also determined that, even if the conveyance had been valid, the Manns would not be entitled to a deduction because neither of their appraisals were qualified appraisals. The court found that Appraisal A was invalid because it calculated the value of the house at its highest and best use, which did not apply to its use by Second Chance. Appraisal B, in the court's view, was invalid because it determined the fair market value of the house's building components when sold on the secondhand market, which was also not consistent with the use of the house for Second Chance's program. The proper way to calculate a tax deduction, according to the court, was to determine the resale value of the specific building materials and contents actually taken from the site.

However, the court upheld the Manns' deductions for their cash donations. The court found that the Manns received no specific benefit in return for the donations. Second Chance's deconstruction services actually benefited Second Chance, not the Manns, the court reasoned, by allowing the charity to convert the overall donation into components that could be sold for value and to fulfill its mission of providing training to disadvantaged individuals. The court also found that the deconstruction services provided no collateral benefit to the Manns, because it did not provide the Manns with the benefit of not having to engage demolition services. In fact, the court found that the deconstruction hindered the progress of the demolition. The court explained that the intangible benefits that came from supporting Second Chance's mission were the hallmarks of a charitable donation, not a transaction for goods and services, and that if such benefits transformed a donation into a quid pro quo, virtually no charitable gift would be deductible.

### Safe Harbor for Luxury Autos and Bonus Depreciation

The IRS addressed a quirky interaction of bonus depreciation under IRC §168(k) and the luxury auto rules under IRC §280F in Revenue Procedure 2019-13. Absent this safe harbor method, taxpayers who opted not to elect out of §168(k) bonus depreciation for an automobile limited by §280F would find any basis in the automobile in excess of $18,000 would not be deductible until the end of the standard recovery period, which would begin in the seventh year after acquiring the vehicle.

Under the Tax Cuts and Jobs Act, a taxpayer is allowed to deduct 100% of the cost of qualifying assets in the year the asset is placed in service for assets placed in service between September 27, 2017, and January 1, 2023. However, under the provisions most often referred to as the "luxury auto rules" a taxpayer's depreciation and/or §179 deduction for covered vehicles is capped at $10,000 for the first year. This amount is adjusted annually for inflation.

IRC §168(k)(2)(F)(i) provided that the first year amount would be boosted by $8,000 per year for vehicles on which 100% bonus depreciation is allowed. In Revenue Procedure 2018-25 the IRS provided that this first year amount would be $18,000 in total for vehicles subject to bonus depreciation under IRC §168(k).

A problem arises since under IRC §280F(a)(1)(B) any depreciation disallowed under §280F(a)(1) during the regular recovery period (normally six years for an automobile) is treated as an expense in the first year following the recovery period, subject to the limitation amount found at
§280F(a)(1)(B)(ii). For automobiles placed in service in 2018 that amount is $5,760.

Thus, if a taxpayer purchased a vehicle for $60,000 in 2018 the allowed depreciation per calendar year would be:

<table>
<thead>
<tr>
<th>Tax Year</th>
<th>Depreciation</th>
</tr>
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<tbody>
<tr>
<td>2018</td>
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<tr>
<td>2019</td>
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<tr>
<td>2023</td>
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<tr>
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<td>5,760</td>
</tr>
<tr>
<td>2031</td>
<td>1,680</td>
</tr>
</tbody>
</table>

That result would be "surprising" to most taxpayers. The IRS has issued this revenue procedure to provide a safe harbor method that will allow taxpayers to take advantage of bonus depreciation on luxury automobiles without forgoing all other depreciation on the vehicle for five years following the year it is placed in service.

The safe harbor method applies to a passenger automobile (other than a leased automobile):

- That has an unadjusted depreciable basis exceeding the first year limitation; and
- For which the taxpayer did not elect to treat the cost or a portion of the cost as an expense under § 179.

Under the safe harbor, the remaining basis of the automobile is depreciated for years 2-5 using an amount equal to the lesser of:

- The basis after the first year deducted amount times the appropriate factor from the 5 years MACRS table found in Table A-1 of Appendix A of Publication 946 or
- The annual limitation on depreciation for the appropriate year found in the appropriate Revenue Procedure for the year the auto is placed in service. For autos placed in service in 2018 that would be Revenue Procedure 2018-25.
1. After April 15th: Making Time for Extended Returns

SURRAN: In recent programs, we have highlighted the various changes and planning opportunities from the enactment of the Tax Cuts and Jobs Act on your clients’ 2018 tax returns, from the impact of using the standard deduction to the complexity of possibly qualifying for the twenty-percent QBI deduction for the owners of pass-through entities. As a result, the new law also had a substantial impact on the return preparation by tax advisers, who were coping with the late release of final regulations by the IRS and their own unfamiliarity with new code provisions, as well as the constant updating of tax software.

FOSTER: One of the signs that this filing season was unusual was the release of statistics from the IRS, confirming what our viewers were reporting: the percentage of electronically-prepared 2018 returns seemed to have declined slightly.

Viewers will recall that our regular expert commentator Barbara Weltman is also the president of Big Ideas for Small Business. She tells us, if it was a case of taxpayers just “mailing in a postcard” in the way that the supporters of tax reform once advocated.

WELTMAN: We know there are no postcard returns. I think it is too early to really know the numbers on electronic filing.

The IRS statistics do not include the increased number of extension requests, which are electronic, and which represent returns that will most likely eventually be filed electronically.

FOSTER: More importantly, our viewers are also confirming another filing season statistic from the IRS: more clients than ever before are extending their 2018 returns – some for the very first time.

WELTMAN: I think that extensions are now understandable. If you are like me, you remember what happened following the Tax Reform Act of 1986. Extensions were common for 1987 returns. That is because of the new law, new tax forms and the unfamiliarity with the new law.

FOSTER: Of course, some of this year’s extensions could be traced to particular reasons. For example, a business that placed so-called “qualified improvement property” in service in 2018 wants to wait to file until they know if they can use bonus depreciation to write off the full cost.

WELTMAN: I think it is true that businesses may want extensions because of uncertainties, such as with the qualified improvement property rules. For write-offs for qualified improvement property, the section 179 deduction can be used. That is really good.

But because we are still waiting for a technical correction on qualified improvement property, the recovery period is 39 years, not the 15 years that was supposed to occur.

I have not given up hope on a technical correction bill. So, obtaining an extension – instead of filing and having to later file an amended return – makes sense to me.

FOSTER: In a similar vein, the lack of technical corrections legislation is not bad news for everyone. Some of our viewers report that their clients, particularly those in New York, have apartments that are in buildings...
that are cooperatives, rather than condominiums. Barbara Weltman tells us, why these co-op owners feel that they can deduct their entire portion of real estate taxes, even if it exceeds $100,000.

WELTMAN: It seems possible that the owners of shares in housing cooperatives, which is common in New York City, may have a way out of the $10,000 SALT cap. This is because co-op owners do not pay property taxes. In fact, they do not actually own property.

They are merely shareholders in the corporation: the housing co-op. Their shares give them the right to occupy a unit and access common areas.

The cap refers to section 164 for deducting taxes. The co-op owner takes deductions under section 216. The cap does not refer to this code section.

It is not clear whether this is a valid interpretation. The Joint Committee on Taxation, in its general explanation of P.L. 115-97 – the so-called “Blue Book” – said that the intent was to make the cap applicable to co-op owners. But that is not exactly what the law said.

Well, the IRS may weigh in, although I am not sure they have the authority to do this.

Or, it might be that legislation is needed to bar co-op owners from being exempt from the SALT cap, and this bar could be retroactive.

What is certain is that co-op owners should consider requesting a filing extension for their 2018 returns. This would give them more time for clarification. Or if they want to file on time, they probably should attach Form 8275 to disclose this position on their return.

FOSTER: Barbara Weltman tells us that what’s good for the owners of cooperatives may not necessarily be good for the owners of condominiums.

WELTMAN: Well, condo owners aren’t in the same boat as co-op owners. They clearly own their property and are clearly subject to the SALT tax on their property taxes.

FOSTER: On the one hand, the IRS did not hesitate to weigh in when states proposed their own work-around for the “cap” on the $10,000 SALT limitation. But on the other hand, it may be up to Congress to provide so-called technical corrections legislation in the same manner as with qualified improvement property.

WELTMAN: Congressional committees are holding hearings in March on technical corrections. So it’s still possible for action soon.

FOSTER: Since Barbara Weltman brought her crystal ball to our videotaping, I reminded her that, besides the technical correction legislation, some of our viewers’ clients really missed their credit for biodiesel, which fell out of the tax code at the end of 2017. She tells us, if we’re likely to see some of the extender provisions revived for 2018 at the same time as any technical corrections legislation.

WELTMAN: The same hearings are going to address extender legislation. In fact, the head of the Senate Finance Committee called for extenders to be enacted and to go through 2019.

So, there is certainty through the end of this year for taxpayers. So yes, it is still possible for extenders to be done.
FOSTER: Of course, it’s not just Congress that tax advisers and their clients are waiting for. It almost goes without saying that we’re still waiting for final guidance from the IRS and the Treasury Department on some areas of the Tax Cuts and Jobs Act.

WELTMAN: Sure, there is much that the IRS and the Treasury can, and still need, to do. Let me give you an example that is not related to the Tax Cuts and Jobs Act.

The IRS and Labor Department issued guidance on the tax treatment of unclaimed 401(k) accounts that are transferred to the states. But the guidance did not say what happens when account owners make claims for their transferred accounts. For example: do these individuals have a 60-day rollover to avoid immediate tax?

There are still many open questions regarding the tax rules for multinationals. And there are still open questions on the qualified business income deduction.

There is sure to be more guidance down the road.

FOSTER: Not surprisingly, our viewers also confirm another aspect of the IRS statistics for 2018 returns. Many of their clients were disappointed because, for the first time, they aren’t going to be receiving refunds or their refunds were substantially less than usual. And not surprisingly, Barbara Weltman was not surprised by the clients’ reaction.

WELTMAN: I am not surprised by the response from some individuals who view their tax refunds as their piggy bank.

And I know some folks who plan a vacation each year based on the size of their tax refund.

And these people may have to take “stay-cations” this year. But people have short memories. Remember, back in February, 2018, the IRS released new withholding tables to reflect changes by the Tax Cuts and Jobs Act. And then employers put these changes into effect.

Those tables saw to it that employees were keeping more of their paychecks. So, in reality, many were receiving their refunds throughout the year. I guess it is a matter of perception.

The Treasury reported that the average refund for the first four weeks of the 2019 filing season was $3,143, which is actually a 1.3% increase from the same period last year. So, it is really too early to tell how the refund picture really looks.

FOSTER: The issue of smaller refunds usually provokes an additional question: To what extent did clients have overly optimistic expectations about their relief from the Tax Cuts and Jobs Act? Or to what extent was there a shortcoming in the estimation software used by tax preparers for 2018 withholding?

WELTMAN: Remember, there was no new W-4 Form to reflect the elimination of the personal and dependency exemptions.

And preparers’ software used for client’s year-end planning could not, by definition, have taken into account the final guidance issued by the IRS in December.

So, the withholding allowances may not have accurately reflected each employee’s situation. Keep in mind that, for 2019, there is still no fully revised W-4 Form. But the IRS has promised a complete overhaul for 2020, so we will be looking for that.
FOSTER: On the one hand, the IRS statistics indicate that the use of a deduction for charitable contributions is increasingly concentrated by high-wealth individuals. But on the other hand, Barbara Weltman does not believe that this is an indication that taxpayers of more moderate wealth are becoming less charitable in their giving.

WELTMAN: This is not surprising. With the doubling of the standard deduction, and no tax advantage to making charitable contributions if not itemizing, who else is going to make the donations?

Of course, many people who use the standard deduction continue to donate to their churches, alma maters and local charities. But because they are not taking an itemized deduction for the donations, you do not see statistics on this.

In June each year, Giving USA releases statistics on annual giving. I will be interested in seeing what went on in 2018 following the changes by the Tax Cuts and Jobs Act.

FOSTER: A few minutes ago, Barbara Weltman provided us with an update on the limitation on the deductibility of state and local taxes. And according to the IRS statistics, there was no correlation between those taxpayers who received refunds this year, and those clients whose SALT deduction was capped for the first time at $10,000.

WELTMAN: This can be explained by several of the tax changes in the Tax Cuts and Jobs Act.

There was an increase in the AMT exemption, so many who previously paid this tax, no longer do. And the standard deduction doubled, while the marginal rates were reduced.

All in all, not bad for many of our clients.

FOSTER: Speaking of the SALT limitation, Barbara Weltman reminds us, of additional potentially good news about state and local taxes for those individuals who claim a home office deduction.

WELTMAN: Keep in mind that claiming a home office deduction can enable a person to fall beneath the SALT cap, or at least get more of a write off for their taxes. For example, say a person has real estate taxes of $5,000. And uses 20% of her home for business. In figuring the home office deduction, $1,000 of the real estate taxes are taken into account here. This means that the itemized portion becomes $4,000, which may be enough of a reduction to allow for itemizing of all SALT.

In any event, it saves $1,000 of the deduction that might otherwise be lost. Check out Worksheet 11 in the instructions to Form 8829 for the home office deduction.

FOSTER: And often times, the good news can be offset by bad news. What about a hypothetical taxpayer whose 2018 state tax deduction was limited to $10,000, but who ended up receiving a refund from the state in 2019? Barbara Weltman analyzes the extent to which a portion of the refund would be considered taxable in 2019.

WELTMAN: Even though the cap is new, the treatment of the tax refund is not new. Under the tax benefit rule of code section 111, the refund is taxable only if it produces a tax benefit.
It is possible that the portion of the refund – equal to the refund times the ratio of income taxes to total state and local taxes subject to the SALT cap – well, that could be treated as income under the tax benefit rule.

FOSTER: Tax advisers are certainly aware that the Academy Awards take place each year during filing season. And they are probably not surprised to learn that the attendees at this year’s Oscar ceremony each received a “swag” bag of over fifty items, valued at just over $150,000.

In a similar vein, neither the participants nor our viewers were surprised when the attendees also received a Form 1099-MISC for the full amount. But some of our viewers did have some clients who were surprised this year: they received a Form 1099-MISC in 2018 from their credit card company or airline travel rewards program. After all, a few years ago on this program, Barbara Weltman told us that, under IRS Announcement 2002-18, those rewards for travel and for purchases are considered nontaxable rebates.

WELTMAN: There is a fine line here. While frequent flyer miles are still not taxed, that is probably because there is an administrative problem about valuation. But now, credit card companies and airlines are issuing Form 1099-MISC for certain bonuses, such as for opening a new account or referring a friend.

These cash bonuses are taxable. They are not a nontaxable rebate. Of course, if your client gets a 1099-MISC for, let’s say miles, that mileage that a credit card company may put a value on. You have to decide: is the value reasonable and do you want to bother contesting it? Remember: the IRS is going to have that 1099-MISC Form. And you have to think about the amounts involved here.

SURRAN: In divorce situations, one spouse or ex-spouse may become legally obligated to make payments to the other party. And since these payments are often substantial, locking in tax deductions for the payer has often been a substantial issue. However, unlike most of the other changes from last year’s tax law, the changes in the rules for alimony just became effective on January 1, 2019, not the year before.

While the payers of alimony no longer receive a tax deduction for their payments, the recipients no longer have to report those payments as income. But there is no tax change – for the payers or the recipients – whose agreements were valid before January first, 2019.

FOSTER: On the one hand, we just heard that the basic rules for the taxation of alimony payments completely changed on January 1st, 2019. But on the other hand, Barbara Weltman explains to us that many of the tax rules that are associated with divorce and marital dissolution still remain unchanged.

WELTMAN: For divorces and separation agreements executed after December 31, 2018, alimony payments are not deductible by the payer or taxable to the payee. But other than that, the basic rules continue to apply.

Child support payments are not deductible by the payee or taxable to the parent receiving the payments on behalf of the child. And you can still use qualified domestic relations orders (QDROs) to transfer retirement plan benefits to a spouse tax-free. Nothing new here.

And transfers of property in the cessation of the marriage are tax-free under code section 1041.
FOSTER: Yes, those transfers of property that are related to the cessation of a marriage are tax-free under code section 1041. But isn’t there a time limit during which the transfers must take place in order to be considered incident to the cessation of the marriage?

WELTMAN: Under regulations, transfers occurring more than six years after the marriage ends are presumed not to be related to the cessation of the marriage, and would be taxable.

However, this is merely a presumption, and it is rebuttable.

FOSTER: In a recent case, the IRS was presented with a situation where the former spouses continued to jointly own property for more than six years after their divorce.

WELTMAN: Recently, we had the situation where a couple who got divorced continued to hold property as tenants-in-common. However, after more than six years from the end of the marriage, the property required costly repairs. The spouse who did not pay for them agreed to transfer her interest to the other spouse.

This transfer was made according to the stipulations in the divorce decree, designed to cover such occurrences.

In a private letter ruling, the IRS said that, because the transfers of the spouse’s interest to the other spouse was done according to the stipulations in the divorce decree, this rebutted the presumption, meaning the transfer was tax-free.

FOSTER: Yes, the transfer was tax-free. But Barbara Weltman explains what happens to the spouse who ends up receiving total ownership of the property.

WELTMAN: The spouse who ends up with the property gets a carryover basis. In other words, that spouse will eventually report the gain that was not recognized during the inter-spousal transfer.

Unless of course, the property is held until death where there is a stepped-up basis.

FOSTER: Of course, the alimony rules are not the only area of the tax code that did not completely take effect in 2018. Viewers will recall that the Tax Cuts and Jobs Act provided us with 100% – instead of 50% – bonus depreciation. And in the case of newly-purchased vehicles, there is a first-year dollar limit of an additional $8000 for the bonus depreciation – unless a taxpayer opts out of using bonus depreciation for all of its five-year property. Barbara Weltman tells us, why we’re discussing this topic in 2019.

WELTMAN: As a general rule, if the 100% bonus depreciation deduction is claimed in the first year, then any remaining basis cannot be depreciated until the recovery period has ended. And the IRS has given this example. Say, you placed in service a car costing $50,000, and took the $18,000 first-year deduction, which included 100% bonus depreciation.

The remaining basis of the vehicle of $32,000 would be recovered beginning in 2024, subject to an annual limitation of $5,760, assuming you still owned the vehicle at that time.

FOSTER: The bad news is that the treatment seems particularly harsh. But the good news is that recent guidance from the IRS – Revenue Procedure 2019-13 – does provide vehicle owners with some relief.
WELTMAN: If you recall, there was a similar situation created by the Tax Relief Act of 2010, when there was a 100% bonus depreciation for September 9, 2010 through the end of 2011. At that time, the IRS created a safe harbor method to avoid the harsh result that is technically required.

Well, now, the IRS has created a similar safe harbor method for vehicles qualifying for the 100% bonus depreciation: the additional $8,000 first year allowance.

FOSTER: Even though a similar situation existed back in 2010, it’s worth it to have Barbara Weltman remind us of the particulars of the Service’s safe harbor method.

WELTMAN: The safe harbor method is an accounting method to mitigate the results that I outlined. It is adopted simply by claiming depreciation for the vehicle in the first year following the year that it is placed in service.

The taxpayer must use the applicable optional depreciation table for figuring depreciation deductions for the vehicle: a car; light truck; or van. This is Table A-1 in Appendix A of Publication 946.

The table with 200% declining balance method, five-year recovery period and half-year convention. The taxpayer claims the first-year limitation, which is the amount in Rev. Proc. 2018-25 for the vehicle placed in service in 2018. So now, we know what to do on the 2019 returns, where taxpayers do not elect out of bonus depreciation.

For a vehicle placed in service after 2018, the IRS will provide further guidance on the first-year limitation.

FOSTER: Presumably, many of those people who bought a vehicle in 2018 have their returns on extension. So, Barbara Weltman runs through the numbers for us.

WELTMAN: Let me give you an example of how this safe harbor method works. Let's say, you bought and placed in service in 2018, a car costing $60,000.

You know that the car is five-year property. And for 2018, you deduct $18,000, which is the limitation in Rev. Proc. 2018-25.

The remaining basis of $42,000 is recovered starting in 2019. For 2019 through 2023, the total depreciation for the car is the annual depreciation rate that you get from Table A-1, multiplied by the remaining adjusted basis of $42,000.

So, for 2019, the allowable depreciation would be $13,440. The Table A-1 rate of 32% times $42,000, which is less than the $16,000 limit that was in Rev. Proc. 2018-25 for the second year.

Well, you get the idea. Use the applicable rate, and deduct the amount as long as it is less than the limit in Rev. Proc. 2018-25, which lists amounts for vehicles placed in service in 2018.

FOSTER: I suppose I’ve got to ask: do we need to use the safe harbor if the purchase is covered by section 179 or if we elect out of bonus depreciation?

WELTMAN: If the taxpayer elects to treat the $18,000 as expensing under section 179, then this safe harbor does not apply.

If bonus depreciation is not used, then there is no need to apply the safe harbor, just do regular depreciation subject to the annual dollar limits.
FOSTER: And presumably the new safe harbor for vehicles ends if and when bonus depreciation terminates.

WELTMAN: The safe harbor is only needed through 2022. Starting in 2023, the 100% bonus depreciation begins to phase out: 80% in 2023, and a further 20% reduction in each subsequent year. No bonus depreciation in 2027, unless Congress extends it.

FOSTER: Since the Tax Cuts and Jobs Act, we've already mentioned the various ways that businesses can write off their research expenses. Barbara Weltman reminds us of the options.

WELTMAN: Currently, a business investing in R&D expenses has three options for handling costs under code section 174: deduct them currently in full; amortize them over a period of not less than 60 months; or amortize them over a 10-year period.

This is an IRC sec. 174 deduction. The business may also qualify for a research credit under IRC sec. 41.

FOSTER: For many tax advisers and their clients, taking the credit AND taking the deduction sounds like double-dipping.

WELTMAN: It is not double-dipping. The reason: if a research credit is claimed, then the amount of the credit reduces what can be deducted.

FOSTER: Okay, so, double-dipping is allowed. But it sounds like only for another three years.

WELTMAN: There is a change that is coming, but it will not apply until 2022. The Tax Cuts and Jobs Act eliminated the expensing election at that time.

As a result, R&D costs will have to be amortized over five years, or 15 years for foreign research.

The credit will still apply. The R&D cost to be amortized will be reduced by any credit claimed.

FOSTER: Yes, it's possible, for now, to double-dip. But according to Barbara Weltman, the rules for the research credit are different than the rules for the deduction under section 174.

WELTMAN: To claim the credit, there is a four-part requirement. The first of which is that the expenses qualify under section 174.

But the credit definition goes further, requiring that research be undertaken to discover information that is technical in nature.

FOSTER: But on last month's program, Barbara Weltman explained that, in addition to a tax credit and a deduction, research expenses can also be used by some employers to offset their share of Social Security taxes.

WELTMAN: I think it is important for small businesses to keep in mind that, instead of using the research credit to offset income tax, they can choose to use up to $250,000 of the credit as an offset to the employer's share of social security taxes under FICA.

These businesses must have gross receipts in the current year of less than $5 million, and no gross receipts in the five-year period ending with the tax year.

FOSTER: And in this regard, I do recall that Barbara Weltman did tell us that the IRS is subjecting research expenses in general, and the research credit in particular, to special audit exposure.
WELTMAN: Last year, the IRS's Dirty Dozen Tax Scams told taxpayers to avoid the misuse of the research credit. The caution said do not include nonqualified activities in the credit, such as payments in excess of the 65% limit for contract research expenses. Unsupported claims of the research credit can also subject a taxpayer to penalties. And as the IRS points out, third parties involved in the preparation and improper claims of the credit can also be subject to penalties.

SURREAS: All of our viewers have clients who are interested in getting a tax break. And chances are, that some of those clients may also be interested in protecting the environment. Charitable contributions of conservation easements allow property owners to obtain a federal tax benefit, while helping to conserve land for public use or enjoyment or to preserve an historic structure.

Through the use of these easements, the ownership of land or a historic building is kept in private hands, but there are restrictions on its use. For many years, property owners have been able to take a generous charitable deduction for qualified contributions, including easements, to a qualified organization exclusively for conservation purposes.

In recent years, many of those individuals have considered – or have been urged to consider – the deductibility of a conservation easement to a charity. To qualify for a charitable deduction, an easement donation must be made exclusively for conservation purposes.

Under section 170 of the tax code, a contribution is made exclusively for conservation purposes, so long as it is made in perpetuity and it is designed to:

One, preserve land for the general public’s outdoor recreation or education;

Two, protect the relatively natural habitats of fish, wildlife or plants;

Three, preserve open space for the public’s scenic enjoyment; or

Four, preserve a historically important land area or structure.

FOSTER: It’s somewhat surprising: this is the second time this year that Barbara Weltman has reported to us on a controversy where the IRS is looking into, and taking action against, a deduction for conservation easements.

WELTMAN: The IRS has been using intense scrutiny for syndicated conservation easements. You may recall that, in 2017, the IRS designated easements by promoters of conservation easements as listed transactions. And the LB&I division of the IRS has a compliance campaign for these conservation easements.

Don’t forget: where the IRS has been successful in challenging large deductions for conservation easements, it means more revenue for the government.

FOSTER: In other words, if our viewers’ clients are considering a conservation easement in general, and a syndicated easement in particular, we should advise them.

WELTMAN: You know that the IRS is going to be looking closely at syndicated conservation easements.
It seems that they are going after those deals with huge ratios: $8 or $9 in write-offs for every dollar invested.

More modest deals – say, $3 or $4 to one – that may not be problematic.

FOSTER: On the one hand, the IRS is profiling conservation easement deductions for audit. But on the other hand, the taxpayers are willing to litigate the IRS actions in the Tax Court.

WELTMAN: There was a regular tax court decision on conservation easements. It is rather fact-specific, but let me try to boil it down.

A partnership donated land in Alabama with a conservation area restricted in perpetuity from commercial and residential development. But the partnership reserved some building areas of unspecified location within the donated property.

The IRS denied charitable contribution deductions here, because the easements were not qualified real property interests.

FOSTER: Once again, the Tax Court sided with the Service. But Barbara Weltman tells us, if there was any saving grace for the partnership.

WELTMAN: The Tax Court agreed with the IRS. The easements did not restrict a specific identifiable piece of real property, because they allowed supposedly conserved land to be taken back and used for residential development.

The only issue was valuation, and the court capped the value of the easement at about $4.8 million.

FOSTER: You’ll recall from our previous program that this is not the first time that this controversy has come up – with painful results for the taxpayer.

WELTMAN: Back in 2014, the Fourth Circuit affirmed a Tax Court decision barring a somewhat similar fact pattern. In that case, the conservation easement was over a golf course surrounded by single-family homes.

While given in perpetuity, the deed allowed the parties to mutually change the property subject to the easement.

FOSTER: It’s bad enough when the IRS is putting conservation easements in its crosshairs. But now, the U.S. Department of Justice is also getting involved.

WELTMAN: The Justice Department is getting involved. It filed suit against promoters who greatly overvalued these donations. The suit is against some parties that promoted and sold ownership in conservation easement syndicate schemes.

According to the complaint, over the last 10 years, the defendants sold at least 96 conservation easement syndicates generating over $2 billion in charitable contribution deductions.

FOSTER: Barbara Weltman tell us, to what extent these lawsuits are likely to deter the use of conservation easements.

WELTMAN: I know that environmentalists hope not. Certainly, conservation easements serve a public purpose. That is why Congress allows a deduction for this partial interest in property. But the promoters who overvalued the donation and hype it to investors may pause if they know the Justice Department is looking at them.

FOSTER: And now, the Congress is getting involved in conservation easements.
WELTMAN: There is pending legislation.

The Charitable Conservation Easement Property Integrity Act of 2019, which is a bipartisan bill, to limit a deduction to transactions not exceeding two and a half times a partner's adjusted basis.

In this political climate, however, even though this bill has bipartisan support, who knows whether it will be enacted?

FOSTER: Before we conclude this month, let’s look at a different area of tax controversy, also involving charitable contributions. In this case, Lawrence and Linda Mann donated their home.

WELTMAN: A couple bought a home in Maryland. And before moving in, decided it needed to be torn down and rebuilt to their specifications. Instead of demolishing it, they donated the home to a charity that teaches people how to demolish homes, and uses the materials obtained from the demolition in their charitable purpose.

The charity called it deconstruction. The couple claimed a deduction for this donation.

The IRS disallowed the deduction because this was a donation of an impermissible partial interest in property. The district court agreed with the IRS.

FOSTER: Of course, I was hoping for a better outcome. Especially because the trial was in a district court in Maryland, where the Manns live, rather than the Tax Court in Washington, where the IRS lives.

WELTMAN: While state law – Maryland, in this case – allowed for the severance of the home from the land. But the couple never took the legal steps for severance.

The district court said that, even if the home had been properly severed, no donation could be allowed here, because of the lack of a qualified appraisal.

As you know, a qualified appraisal is required for a property donation valued at more than $5,000, other than for publicly traded securities.

FOSTER: Yes, the court said that the Manns needed a qualified appraisal. Barbara Weltman tells us, what was wrong with the two appraisals they had as well as the estimate provided by the charity.

WELTMAN: The couple here obtained two appraisals, but neither would have been satisfactory. The first one was based on the highest and best use, which would not be relevant for demolition. And the second one was also inconsistent with the demolition.

The charity merely gave them an estimate of the salvage value. But this did not amount to a qualified appraisal.

FOSTER: As I think about it, I seem to recall that Barbara Weltman told us about a similar case a few years ago: where the homeowner, Ted Rolfs, took a charitable contribution for allowing the local fire department to demolish his home.

WELTMAN: Very good. Yes, the Tax Court, back in 2010, in a case called Rolfs, disallowed a charitable contribution deduction for a home donated to a fire department. The couple wanted their home demolished, and the fire department got a home that could be used for training purposes.
The reason for the denial of the deduction? The couple received a substantial benefit from the donation: they did not have to pay for the demolition.

And unlike the current case, there was no salvage value involved.

FOSTER: I do have one final question for Barbara Weltman this month about deconstruction, since several of our viewers have clients who have been approached about these deductions in a commercial context. In these cases, the developer provides the building owner with certified information on how the materials from the demolished structure will be reused in a “new” edifice to be constructed by a not-for-profit organization. Barbara Weltman concludes our program, by telling us whether this commercial approach – as opposed to Ted Rolfs’ home or the home owned by Lawrence and Linda Mann- could pass the IRS’ “smell test.”

WELTMAN: It depends on the situation.

You have to be sure you have a good appraisal that accurately measures the real value of the reused materials.

Remember: in the Mann case, the two appraisals both fell short of what is needed to be a good qualified appraisal.
Segment Two
2. Tax and Estate Planning: The Road Ahead

Learning Objectives:
Upon successful completion of this segment, you should be able to:
- Identify the professions that are considered "specific service trade or business" for purposes of sec. 199A;
- Identify the accounting changes that small businesses can make on their tax returns;
- Explain how the Wayfair decision changes the way states can assess and collect their taxes; and
- Distinguish between assets that have beneficiary designations and those that are passed by will or probate.

Segment Overview:
Since the sweeping changes to the Internal Revenue Code from the Tax Cuts and Jobs Act, the IRS continues to provide regulatory guidance on how enterprises should reflect the new provisions on their 2018 business tax returns. Edward Zollars, a partner in Thomas, Zollars & Lynch, Ltd. and a discussion leader for Kaplan Professional, reports on a number of business tax issues causing continued concern and what information you may still be required to obtain.

Field of Study:
Taxes

Expiration Date:
July 7, 2020

Course Level:
Update

Course Prerequisites:
Work experience in tax planning or tax compliance, or an introductory course in taxation.

Advance Preparation:
None

Recommended Accreditation:
1 hour group live
2 hours self-study

Required Reading (Self-Study):
“The Road Ahead: Planning for Income and Estate Taxes”
By Ed Zollars, CPA, of Kaplan Professional
Excerpted with permission from Current Federal Tax Developments
For complete report, go to: www.currentfederaltaxdevelopments.com
See page 2-11.

Video Transcript:
See page 2-17.

Running Time:
30 minutes
I. Section 199A Ramifications

A. Qualified Business Income (QBI): IRC Sec. 199A
   i. 20% deduction for owners of pass-through businesses
   ii. As alternative to tax rate cut for C corporations

B. Specified Service Trade or Business (SSTB)
   i. Health
   ii. Law
   iii. Accounting
   iv. Actuarial science
   v. Performing arts
   vi. Consulting
   vii. Athletics
   viii. Financial services
   ix. Brokerage services
   x. Reputation/skill of owner

C. Coping with Sec. 199A Deduction

D. Ed Zollars’ Crystal Ball
   i. Expect lots of activity on 199A for next few years, like passive losses in 1986
   ii. But don’t expect repeal of 20% deduction for qualified business interest

II. Accounting Method Changes

   i. Automatic changes to method of accounting for IRC sec. 451(b)
   ii. Audit protection with filing Form 3115

B. Elective Changes for Businesses with Revenues of Less than $25 Million
   i. Remain on cash basis
   ii. Avoid sec. 471 inventory rules
   iii. Eliminate uniform capitalization under sec. 263A
   iv. Disregard percentage of completion method
III. State Tax Issues

A. South Dakota v. Wayfair (U.S. Sup. Ct., 6/21/2018)
   i. Can require businesses to collect and remit sales taxes, even if no physical presence in state
   ii. Overrules precedents: National Bellas Hess (1967) and Quill (1992)
   iii. Eliminates “advantage” of remote sellers over local businesses

B. After Wayfair, States Are Aggressively
   i. Pursuing income tax claims against out-of-state companies
   ii. Oregon wins against Capital One Auto Finance in state court
   iii. Now is time for businesses and tax advisers to review income tax liability

C. Federal Response in 1959 to Changes in State Taxes
   i. Supreme Court decides Northwestern States Portland Cement Co.
   ii. Congress enacts P.L. 86-272 to overturn court decision

D. Future Expansion of Wayfair?
   i. Because congressional views are based on whether their state has a sales tax, Congress is not likely to address state tax issues
   ii. Zollars: pretty soon, every state with a sales tax will enforce out-of-state collection

E. Workaround to $10,000 SALT Deduction
   i. Pass-through entities: can elect to be treated as C corp. on state returns
   ii. Zollars: pretty soon, other states will consider alternative workarounds

“So, you need to be ready to adapt to the fact that you might have to change what you were planning to do based on guidance coming out during 2019.”
—Edward Zollars

IV. Beneficiary Designations: General Guidelines

A. Assets with Beneficiary Designations
   i. Will not go through probate
   ii. Will transfer to beneficiary at your death

B. Most Common Assets with Beneficiary Designations
   i. Retirement accounts
   ii. Life insurance contracts/annuities
   iii. Payment on death/transfer on death
   iv. Jointly held assets

C. Beneficiary Designations
   i. Should be reviewed after every life “event”
   ii. Are very easy to change, but are often overlooked
V. Beneficiary Designations: Divorce Situations

   i. 401(k) retirement plan should be paid to ex-wife
   ii. Not to daughter who was supposed to inherit $402,000

B. Revocation on Divorce Laws: Uniform Probate Code
   i. Half of the states have enacted laws to ignore beneficiary designation for a divorced spouse in favor of a contingency beneficiary
   ii. But you can decide to benefit a divorced spouse, if you want

C. Sveen v. Melin (Sup. Ct., 6/18/2018)
   i. Sveen died, but insurance policy still designates ex-wife Melin as beneficiary
   ii. Minnesota state law removes Melin, names 2 children as beneficiaries
   iii. Even though the Revocation on Divorce Law was enacted after Sveen bought the policy

D. Give Away Assets Before They Appreciate
   i. To use less exemption
   ii. To pay less tax

   “But I think there is a good reason to consider planning right now. I mean, remember that a gift is taxed based on the value of the gift at the time of transfer.”

   — Jeff Kolodny
Group Live Option

Instructions for Segment

For additional information concerning CPE requirements, see page vi of this guide.

- As the Discussion Leader, you should introduce this video segment with words similar to the following:
  “In this segment, Edward Zollars reports on a number of business tax issues arising from changes to the IRC that are causing concern and on what information you may still be required to obtain. In addition, Jeffrey Kolodny explains why checking a client’s beneficiary form is vital to any tax planning activity.”

- Show Segment 2. The transcript of this video starts on page 2–17 of this guide.

- After playing the video, use the questions provided or ones you have developed to generate discussion. The answers to our discussion questions are on pages 2–7 and 2–8. Additional objective questions are on pages 2–9 and 2–10.

- After the discussion, complete the evaluation form on page A–1.

Discussion Questions

2. Tax and Estate Planning: The Road Ahead

You may want to assign these discussion questions to individual participants before viewing the video segment.

1. Because of our ability to “weather” the initial filing experience for the 20% qualified business income deduction under IRC sec. 199A, Edward Zollars does not believe that the current method for pass-through taxation is likely to be repealed. Do you agree or disagree? To what extent did you finalize returns for which the 199A deduction was applicable? With what degree of comfort or of difficulty?

2. Edward Zollars noted the greatest difficulties he experienced was for pass-through businesses in a specified service trade or business (SSTB) that earned in the so-called “phase-out” range for the deduction [above $157,500/$315,000, but below $207,500/$415,000]. Do you agree or disagree with his assessment? How helpful was the software you used in developing the returns? To what extent did your clients consider other tax strategies, such as married filing separately, to maximize their benefits?

3. According to Ed Zollars, most businesses must now recognize income for tax purposes no later than the year in which it is recognized on their financial statements. How will your clients assure the conformity between tax accounting and financial accounting? To what extent will this change have an impact on your work for them? To what extent will it affect your clients’ adoption of the revenue recognition standard?
4. In the wake of the Wayfair decision, Ed Zollars observes a heightened interest by state governments in pursuing income tax claims against out-of-state businesses. To what extent are your clients focused on their new “nexus” for income taxes as well as for collecting and remitting sales and use taxes? To what extent are you reviewing their potential liability for state income and gross receipt taxes?

5. Many individuals have given up their quest for a “workaround” to deducting more than $10,000 of state taxes on their federal returns. Yet, Ed Zollars approvingly notes the mechanism by which pass-through businesses in Wisconsin and Connecticut can elect to be treated as C corporations on their state returns. To what extent are you familiar with these approaches to deducting state taxes? How encouraging or discouraging are you if pass-through clients raise the issue of making an election only for state tax purposes?

6. Jeffrey Kolodny advocates that all tax advisers provide at least a minimum of estate planning advice for their clients: a regular review of the beneficiary designations on your clients’ IRA and retirement plans. Why is this practice so important? Why is it particularly essential after a divorce or a marital dissolution?

7. As an estate planner, Jeffrey Kolodny believes that clients should be making gifts to family members and others now, even though the rates are scheduled to remain low and the thresholds are scheduled to remain high for another seven years. To what extent are your clients interested in discussing their estate planning? To what extent would your clients consider revising their current estate plans to take advantage of the existing laws?
Suggested Answers to Discussion Questions

2. Tax and Estate Planning: The Road Ahead

1. Because of our ability to “weather” the initial filing experience for the 20% qualified business income deduction under IRC sec. 199A, Edward Zollars does not believe that the current method for pass-through taxation is likely to be repealed. Do you agree or disagree? To what extent did you finalize returns for which the 199A deduction was applicable? With what degree of comfort or of difficulty?
   - Participant response is based on your practice and its structure, on your clients – their activities, their risk tolerance, and their filing habits – as well as on your perspective and experience.

2. Edward Zollars noted the greatest difficulties he experienced was for pass-through businesses in a specified service trade or business (SSTB) that earned in the so-called “phase-out” range for the deduction [above $157,500/$315,000, but below $207,500/$415,000]. Do you agree or disagree with his assessment? How helpful was the software you used in developing the returns? To what extent did your clients consider other tax strategies, such as married filing separately, to maximize their benefits?
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6. Jeffrey Kolodny advocates that all tax advisers provide at least a minimum of estate planning advice for their clients: a regular review of the beneficiary designations on your clients’ IRA and retirement plans. Why is this practice so important? Why is it particularly essential after a divorce or a marital dissolution?

- Jeffrey Kolodny notes that tax advisers are often “blamed” when expected beneficiaries do not receive funds from an estate. He also indicates that state statutes can automatically revoke some beneficiary designations after a divorce.
- Participant response is based on your practice and its structure, on your clients – their activities, their risk tolerance, and their filing habits – as well as on your perspective and experience.

7. As an estate planner, Jeffrey Kolodny believes that clients should be making gifts to family members and others now, even though the rates are scheduled to remain low and the thresholds are scheduled to remain high for another seven years. To what extent are your clients interested in discussing their estate planning? To what extent would your clients consider revising their current estate plans to take advantage of the existing laws?

- Participant response is based on your practice and its structure, on your clients – their activities, their risk tolerance, and their filing habits – as well as on your perspective and experience.
Objective Questions

2. Tax and Estate Planning: The Road Ahead

You may want to use these objective questions to test knowledge and/or to generate further discussion; these questions are only for group live purposes. Most of these questions are based on the video segment, a few may be based on the required reading for self-study that starts on page 2–11.

1. Which of the following would be the most difficult situation for coping with Section 199A deductions according to Ed Zollars?
   a) single taxpayers with taxable income below $157,500
   b) single taxpayers with taxable income above $207,500
   c) married taxpayers with taxable income between $315,000-$415,000
   d) married taxpayers with taxable income above $415,000

2. Which one of the following would qualify as a specified service trade or business as it relates to Section 199A?
   a) education
   b) accounting
   c) construction
   d) transportation

3. Which of the following is correct regarding tax accounting for businesses with revenues under $25 million?
   a) The company can elect to report on a cash basis.
   b) The entity must adopt Section 471 inventory rules.
   c) Companies must comply with Section 263A uniform capitalization guidelines.
   d) Small contractors must use the percentage of completion method to recognize revenues.

4. What types of state taxes were the subject of the Wayfair Decision challenging the physical presence requirement?
   a) payroll
   b) franchise
   c) sales and use
   d) income

5. According to Ed Zollars, how many states thus far have enacted Wayfair-style provisions either administratively or by law?
   a) 7
   b) 17
   c) 30
   d) 42

6. Which of the following correctly identifies a finding in the U.S. Supreme Court case of Kennedy vs. Plan Administrator according to Jeff Kolodny?
   a) The court upheld the change made by the decedent to the beneficiary designation.
   b) The court held that the plan payout should be governed by the divorce settlement as opposed to what the beneficiary designation provided.
   c) The court ruled that the plan administrator incorrectly paid out assets to the surviving spouse.
   d) The court ultimately held that a waiver by a spouse in a divorce action is not the same thing as a change in a beneficiary designation under a 401(k) plan.

7. Which of the following refers to the revenue recognition test a taxpayer must comply with to satisfy the requirements of IRC 451(b)(1)(A) as amended by the TCJA?
   a) bright line
   b) percentage completion
   c) all events
   d) accrual
8. Which of the following is required for determining that there are two distinct trades or businesses being conducted for the purposes of applying Regulation 199A?
   a) same method of accounting used for each trade or business
   b) different geographical location for each trade or business
   c) neither can be a service trade or business.
   d) separate set of books kept for each trade or business

9. What was the type of property that included a beneficiary designation that was the subject of the U.S. Supreme Court case Sveen v. Melin?
   a) IRA
   b) life insurance
   c) annuity
   d) real estate

10. Which of the following is correct regarding beneficiary designations for financial accounts involving an account agreement?
   a) Acceptance of the beneficiary designation is at the discretion of the company.
   b) An account agreement CANNOT impose restrictions and controls on the disposition of property.
   c) A company CANNOT reject a beneficiary designation that is long or complicated.
   d) A beneficiary designation is considered effective as soon as it is mailed.
Self-Study Option

Instructions for Segment

When taking a CPA Report segment on a self-study basis, an individual earns CPE credit by doing the following:

1. Viewing the video (approximately 30–35 minutes). The transcript of this video starts on page 2–17 of this guide.
2. Completing the Required Reading (approximately 25–30 minutes). The Required Reading for this segment starts below.
3. Completing the online steps (approximately 35–45 minutes). Please see pages iii to v at the beginning of this guide for instructions on completing these steps.

Required Reading (Self-Study)

THE ROAD AHEAD: PLANNING FOR INCOME AND ESTATE TAXES

By Ed Zollars, CPA, of Kaplan Professional
Excerpted with permission from
Current Federal Tax Developments
For complete report, go to:
www.currentfederaltaxdevelopments.com

Converting from an Impermissible Method to a Permitted Method

Rev. Proc. 2018-60 was released by the IRS to allow taxpayers to obtain consent to change from their current method of accounting to take into account the requirements of IRC §451(b)(1)(A), added by the Tax Cuts and Jobs Act, effective for tax years beginning in 2018. But is that automatic change still available if the method the taxpayer had previously been using was one not allowed for tax purposes?

In CCA 201852019, the IRS Chief Counsel’s office decided the answer was yes.

IRC §451(b)(1)(A) provides:

(A) In General.

In the case of a taxpayer the taxable income of which is computed under an accrual method of accounting, the all events test with respect to any item of gross income (or portion thereof) shall not be treated as met any later than when such item (or portion thereof) is taken into account as revenue in -

(i) an applicable financial statement of the taxpayer, or

(ii) such other financial statement as the Secretary may specify for purposes of this subsection.

The memorandum poses the following facts for analysis:

Taxpayer is an accrual method taxpayer with an applicable financial statement that files its tax return on a calendar year basis. Taxpayer proposes to adopt a method under Rev. Proc. 2018-60 to comply with § 451(b), as amended by section 13221 of the Tax Cuts and Jobs Act, Pub. L. No. 115-97 (December 22, 2017)(TCJA). Taxpayer’s present method of accounting is an impermissible method that does not comply with either the all events test of § 451, as amended by the TCJA or with § 451, prior to being amended by the TCJA.

The memo notes that the Revenue Procedure applies to a taxpayer who seeks
to change to a method that “treats an item of gross income, or portion thereof, as meeting the all events test no later than when such item, or portion thereof, is taken into account as revenue in its AFS [applicable financial statement] under § 451(b)(1)(A).”

An election under this method will, by its nature, automatically also require the taxpayer to use a proper accounting method under the all events test for tax purposes even if the AFS is not reporting revenue as rapidly as the all events test. As the memorandum provides:

Rev. Proc. 2018-60 provides automatic consent for method changes to comply with §451(b)(1)(A), as amended by the TCJA. The operative rule set forth in § 451(b)(1)(A) includes the requirements of the all events test under § 451(b)(1)(C). Thus, to satisfy § 451(b)(1)(A), a taxpayer must also comply with the all events test as defined in § 451(b)(1)(C).

Thus, the CCA concludes:

Accordingly, a taxpayer that complies with all the terms and conditions set forth in Rev. Proc. 2018-60, may obtain automatic consent of the Commissioner to change from a method that is impermissible under § 451(b)(1)(C) to a permissible method that complies with § 451(b)(1)(A), as amended by TCJA.

Note that the taxpayer in this case will not be allowed to use its prior inappropriate tax method for cases where the AFS may still use that old method to slow recognition of revenue for tax purposes. Rather, for tax purposes the taxpayer will need to move to a correct application of the all events test in those cases.

It seems possible, based on this analysis, that this result would be available even if the taxpayer’s AFS never creates a situation where a more rapid recognition would be required—thus creating an opportunity for a taxpayer to obtain automatic permission to change from an otherwise impermissible method of recognizing revenue in cases where the all events test would normally apply.

Separating SSTB and Non-SSTB Activities into Separate Businesses

The proposed regulations on the qualified business interest deduction clearly indicate that a single individual or entity can conduct more than one trade or business. (See, for instance, Prop. Reg. 1.199A-3(b)(5) and 1.199A-4(a).) But these regulations do not provide for a test to divide up a single trade or business.

However, such a test does exist at Reg. §1.446-1(d) for the use of different methods of accounting, even if it’s not quite a “bright line” test for what is a separate trade or business. That regulation provides:

(d) Taxpayer engaged in more than one business.

(1) Where a taxpayer has two or more separate and distinct trades or businesses, a different method of accounting may be used for each trade or business, provided the method used for each trade or business clearly reflects the income of that particular trade or business. For example, a taxpayer may account for the operations of a personal service business on the cash receipts and disbursements method and of a manufacturing business on an accrual method, provided such businesses are separate and distinct and the methods used for each clearly reflect income. The method first used in accounting for business income and deductions in connection with each trade or business, as evidenced in the taxpayer's income tax return in which such income or deductions are first reported, must be consistently followed thereafter.

(2) No trade or business will be considered separate and distinct for purposes of this paragraph unless a complete and separable set of books and records is kept for such trade or business.

(3) If, by reason of maintaining different methods of accounting, there is a creation or shifting of profits or losses between the trades or businesses of the taxpayer (for example, through inventory adjustments, sales, purchases, or expenses) so that income of the taxpayer is not clearly reflected, the trades or businesses of the
taxpayer will not be considered to be separate and distinct.

Absent some additional guidance in final regulations on how applying “trade or business” to §199A would be different, the above regulation would appear to provide the best guidance. Note that the regulation has two key requirements to respect the trade or business:

- A complete and separate set of books must be kept for each trade or business of the taxpayer/entity and
- Shifting of income between the entities through sales, purchases or expenses will be fatal to a finding of two businesses.

In Chief Counsel Advice 201430013 the IRS National Office looked at a case where a subsidiary converted to a single member LLC disregarded entity. The memorandum concludes that, in fact, there are two distinct trades or businesses in this organization.

The activities undertaken by the LLC and its corporate owner were summarized as follows:

Company’s activities include sales, marketing, distribution, sale support, research and development, and administrative and headquarters functions. LLC primarily manufactures products but does provide some research and development services to the purchaser of its products, Purchaser A. Purchaser A will subsequently sell these products to Purchaser B, who will ultimately sell the products to Company.

Company and LLC have separate books and records. These books and records are prepared at Company’s location. Company and LLC are in different geographical locations. Further, Company and LLC do not share employees, but, do share the highest-level executives. Company and LLC use the same accounting method, presumably, that method is an accrual accounting method.

The memorandum concludes:

Deciding whether Company and LLC are separate and distinct trades or businesses requires a factual determination. The currently available information fails to convince us that Company and LLC are not separate and distinct trades or businesses. The fact that LLC has failed to make an election to be taxed as a corporation and is thus, disregarded as an entity separate from Company for federal income tax purposes, does not mean that LLC can never be a separate and distinct trade or business. Accordingly, based on the available information, our view is that Company and LLC are separate and distinct trades or businesses within the meaning of IRC § 446(d).

So does that mean that a single entity can be divided into multiple trades or businesses—likely yes, but they need to be truly distinct.

Example 1: A & B, Inc. is an S corporation. A & B is a licensed CPA firm that provides auditing, accounting and tax services to individuals and businesses. As well, A & B offers seminars on tax, technology and business topics that qualify for professional continuing education for CPAs, EAs and various other professionals. The seminars are conducted by a specific group of individuals in the corporation. There is no overlap between the customers of the accounting services performed by A&B (businesses and individuals seeking tax planning and preparation) and those that purchase seats at the seminars (tax professionals seeking to obtain education). 65% of A&B’s revenue for the year came from seminar fees and 35% came from accounting services.

A&B records all activity in one set of books to record revenue and expenses for all revenue and expenses of the company. All administrative functions are performed by the same employees for both the accounting services and the seminars. The accounting services and seminars are both operated in the same physical location.
Due to the fact that separate books and records are not kept and the operations are begin run on an integrated basis, it appears that A&B may have a difficult time showing that there are truly two separate trades or businesses being conducted. In that case, it seems likely that all income from A&B will be tainted as coming from an SSTB.

**Example 2:** Assume the same facts except the accounting firm and seminars operate out of offices located in separate offices. Each office has its own administrative staff and maintains its own set of books. However, the officers of A&B, who are also the shareholders, both conduct all of the seminars and are lead members of the engagement teams on accounting and tax engagements. They carefully account for their time, and their salaries are divided between the two divisions based on time expended.

In this case, it seems likely that A&B can show it is operating two distinct trades or businesses. The accounting business is clearly still an SSTB. But the seminar business would appear in the business of education, which is not an SSTB. As such, the income related to the education business would appear not to be subject to the restrictions on claiming a §199A deduction from a specified service trade or business.

**The Importance of Up-to-Date Beneficiary Designations**

A Minnesota law that invalidated beneficiary designations to spouses after a divorce does not violate the contracts clause when applied to a policy purchased before the law’s enactment, the U.S. Supreme Court has ruled. Justice Elena Kagan was joined by seven other justices in her majority opinion in *Sveen v. Melin*. Justice Neil M. Gorsuch dissented.

In recent years, more than one-half of the states (26, at last count) have adopted “revocation on divorce” laws that revoke beneficiary designations to former spouses. The laws are based on a 1990 amendment to the Uniform Probate Code adopted on the assumption that failing to change a beneficiary after divorce likely stemmed from “inattention” not “intention,” Kagan said.

For instance, under Minnesota law, a policyholder or court could override the revocation of the beneficiary. There was no such override in the divorce of Kaye Melin and Mark Sveen. Sveen’s life insurance policy had designated Melin as a primary beneficiary and his two children from a prior marriage as contingent beneficiaries.

When Sveen died, the children claimed they were the rightful recipients of the life insurance proceeds. Melin argued the Minnesota law violated the contracts clause because the life insurance policy was purchased before the law’s enactment. The clause bars states from passing laws “impairing the obligation of contracts.”

The case resolves a split of authority on whether such revocation laws can apply to pre-existing beneficiary designations. The threshold issue in contracts cases is whether the state law has operated as a substantial impairment of a contractual relationship. Here, there is no substantial impairment, Kagan said. “First, the statute is designed to reflect a policyholder’s intent—and so to support, rather than impair, the contractual scheme,” she wrote. “Second, the law is unlikely to disturb any policyholder’s expectations because it does no more than a divorce court could always have done. And third, the statute supplies a mere default rule, which the policyholder can undo in a moment.”

The U.S. Supreme Court rarely considers domestic relations or probate cases. Nonetheless, until now, when state statutes regulating insurance benefits and retirement designations upon divorce conflict with federal statutes, the Court has repeatedly held the state statutes preempted.

**Time to Review Your Clients’ Beneficiary:** Typically, it’s yet another form in that seemingly endless pile of paperwork needed to complete the application. It’s usually only one page and while most clients don’t seem to think about it too much, others will want to get back to you
required reading

on their choices—another delay to getting business processed. Since the beneficiary form can be changed at any time, does it really matter what the client decides when processing the paperwork?

Of course it does—for two important reasons. First, as more and more assets pass by beneficiary designation, this form has become the client’s primary method of passing assets to their beneficiaries. Second, clients rarely initiate changes in beneficiary designations, so a “temporary” solution may become permanent, perhaps with unintended results.

The scope of property passing by designation has increased significantly in recent years. Traditionally, this property was limited to life insurance, annuities, retirement accounts and bank accounts. More recent additions include all types of financial and securities accounts, and even real estate in some states.

Some of the accounts may be designated as “Transfer on Death” or “Payable on Death,” but the result is generally the same. It is the beneficiary designation and not the will that controls the disposition of this property at death. Consequently, clients may find that few assets actually pass pursuant to traditional estate planning documents.

Since, as a matter of contract law, the property passes according to the designated beneficiary, the account agreement can impose restrictions and controls on the disposition of property. Acceptance of the beneficiary designation is at the discretion of the company; and designations that are long or complicated may be rejected or require additional documentation.

It is important to ensure that procedures are followed. In general, a beneficiary designation is not effective until it is received and accepted by the company. Simply mailing the form may not be sufficient; advisors should follow up with the company to ensure that the beneficiary designation is properly recorded.

So what started out as the easiest form to complete in the account set-up paperwork requires a lot more time and thought.

Advisors can set themselves apart by demonstrating that they understand the importance of the beneficiary designation and issues associated with “keeping it simple.” And once the beneficiary designation is set up, it is only good if it reflects the clients’ current wishes.

An IRA payable to a former boyfriend? Life insurance payable to parents rather than the wife and children? An annuity payable to a former spouse, a long dead relative or a former best friend who is now married to an ex-spouse?

The beneficiary designation may have been appropriate at the time—but times change. If you or the client thinks an outdated beneficiary will “do the right thing” and hand over the money, think again. While it does happen, many cases prove otherwise. The following are four common life changes to keep tabs on.

(1) Change in marital status: If the client is getting married for the first time, then he or she may want to change the beneficiary to the spouse; however, this change may be less likely if it is a second or later marriage. While naming the spouse as beneficiary is generally easy for accounts with current employers such as life insurance and retirement benefits, accounts at former employers or amounts that have been rolled over from former employers often get forgotten.

More frequently, problems usually arise when the client gets divorced. In some states, beneficiary designations cannot be changed until the divorce becomes final. In other states a divorce has the effect of cancelling all revocable designations for the former spouse. However, sometimes the former spouse has to be named as beneficiary while the children are minors. To avoid any uncertainty, your clients should update their beneficiary designations.

(2) Birth or adoption of children or grandchildren: The birth or adoption of the first child usually prompts a major review of the estate plan and the need for new contingent beneficiaries. If a child is named individually (rather than as a member of a “my children” class), then the designation
will need to be reviewed and possibly updated as additional children are born.

The same considerations apply to grandchildren. If children are adopted, it may be necessary to ensure they are included in the definition of children.

(3) Death of beneficiaries: The death of a spouse will likely prompt a major review of the beneficiary designations as property will now generally be passing to the next generation at the death of the client. Distribution options will have to be carefully considered as alternatives for children and/or trusts for their benefit may result in reduced or significantly different tax and payout consequences.

The death of one member in a group of beneficiaries may, depending on the account agreement, result in larger shares for the remaining beneficiaries. If this is not the intended result, then the designation needs to be updated.

The situation results in problems much more frequently than it should. A common situation is when “children” are designated as beneficiaries. Under some account agreements, the death of one child will result in the other living children receiving the share of the deceased child.

This excludes the descendants of the deceased child, a probably unintended consequence. To prevent this, the designation should be changed to include a share for the descendants of the deceased child or changed to “per stirpes.”

(4) Major life changes, change of plans and dislike of beneficiaries: A major life change, such as job change, relocation or retirement, is a good opportunity to review all details, including beneficiary designations, as part of the effort to consolidate and simplify planning.

As clients age, their plans may change and their likes and dislikes may also change. The need for trusts for the children may either go away or become more important as they grow up. Concern about spouses of children may have diminished or become heightened. Clients may need more or less complicated planning because of the size of their estate, changes in tax laws or changes in states of residency.

Finally, beneficiaries may fall into and out of favor for all sorts of reasons. Changes for whatever reason need to be reflected in the beneficiary designations.

A regular beneficiary review will help bring peace of mind and added value to the client. The advisor can also be sure there will be no nasty surprises or awkward conversations after the client’s death. As part of their periodic review, tax advisors should always ask about changes in their clients’ situations. Providing such a service to clients will enhance your reputation for value-added service and ensure that both you and the client can sleep at night!
2. Tax and Estate Planning: The Road Ahead

SURRAN: One of the most anticipated—and most discussed—provisions in the Tax Cuts and Jobs Act is the deduction for qualified business income, known as QBI. Generally, the new deduction—under new code section 199-A—allows a deduction for up to twenty percent of QBI by the owners of partnerships, limited liability companies, S corporations, trusts, estates, and various types of sole proprietorships.

Essentially, the provision is expected to be a significant tax benefit for many non-corporate businesses, and was enacted in part on the premise that a sizable permanent tax rate cut for C corporations—from a maximum graduated rate of 35% down to a flat 21% rate—justified some tax benefit for the owners of non-C corporation businesses.

WILLIAMS: You may recall that we brought you up-to-date with the proposed and final regulations that were issued just before “spring busy season” by the IRS. Of course, the new QBI deduction has special treatment as well as specific rules for those businesses that provide a so-called specified service trade or business. Under section 199A, a specified trade or business involves the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees.

But how should tax advisers tackle the issues that a specified service trade or business—known as an SSTB—brings forward?

Fortunately for us, Edward Zollars is a discussion leader for Kaplan Professional Education as well as a CPA and a partner in the firm of Thomas, Zollars and Lynch.

WILLIAMS: Ed Zollars explains why, in his experience, tax advisers should be most concerned about how section 199A affects those clients whose taxable income is just above the so-called phase-out range.

ZOLLARS: The most important thing to do, when we talk about 199A deductions, is I try to warn people is make sure that we are not dealing with a problem that is not going to ultimately make a difference to your client.

For instance, the first thing you need figure out is: what's my client’s taxable income?

If that taxable income is below the threshold amount, this thing gets a whole lot simpler. And actually, if it is way above the threshold amount, this thing does not get terribly difficult.

The messy area is going to be those clients who fall in that magic range: taxable income before 199A pay for a married couple from $315,000 to $415,000, or for other taxpayers from $157,500 to $207,500. That is the messy category.

That category has all the problems of the other categories, plus its own crazy phase-out rules. And by the way, that calculation and the mess in there is why the IRS has delayed so long getting that guidance public, because it is a mess to calculate. So, the first thing I want to make sure is
you want to stratify your clients, to be honest, at first, into your three categories.

Those below the phase-out limits, you are basically going to look at their Schedule C income or partnership income. And you are just going to pick up the 20% – that is going to be relatively simple: just exclude things like guaranteed pay from a partnership and exclude other issues.

Don't worry about those sorts of things, that will be pretty easy. For those above $415,000, guess what: if they are an attorney, they do not get it. If they are a doctor, they do not get it. Above $415,000, that also simplifies it, because that takes a lot of people off the list.

And those in the middle, well, those are the ones you're probably going to be waiting and double and triple-checking. The most complicated returns are going to be those who are in that phase-out range, that have a specified service trade or business, and have limited amounts of W-2 wages or basically property that will count for the special unadjusted basis immediately after acquisition (UBIA) calculation for property basis.

Those clients that have both those limitations in play are by far the messiest group out there. So to simplify your world realize most of your clients are not going to fall into that magic category and that magic category is where all the problems exist.

There are lots of exceptions to 199A. Obviously, the best known is the specified service trade or business. Now, that only applies if your income your taxable income gets above certain limitations: $315,000 for a married couple filing joint return or $157,500 for all others this year, and then it phases out over $100,000 for the married couple, 50,000 for the others.

But there are other areas that do not count. For instance, if you are any service as an employee do not count. And the key there is, if you have ever been employed at the organization that you are now claiming to have this income coming from, the law provides a presumption you are still an employee. You have to prove you are not.

Also guaranteed payments from a partnership do not qualify for the 20% deduction.

That is interesting because, while a guarantee payment does not, a special allocation does. And here is where it becomes interesting: you have to read the partial agreement to find out for sure: do we have a guaranteed payment as the law defines a guarantee payment under IRC sec. 707 or do we have a special allocation?

WILLIAMS: In coping with section 199A, many tax advisers – as well as many clients – came to the conclusion that Congress should have just stayed with their original proposal: to provide a special tax rate for pass-through entities that was slightly higher than the new low tax rate for corporations, but slightly lower than the highest rate for individual taxes. Ed Zollars wonders if it is now too late for Congress to abandon the QBI deduction.

ZOLLARS: If we survive the first year with sec. 199A, unfortunately, I suspect we are with it for life. That is the sort of thing that Congress is likely to keep around. If we got through the first year, and we calculated it, then they are going to say: "Well, see, it wasn't that tough."

And we are going to spend the next five, six or seven years, with court cases, rulings, IRS guidance. People trying to work around all that. Stuff
is going to happen, just like it did for those who remember the 1986 Tax Act. We spend all that time trying to figure out what a “passive activity” was and how it impacted things, etc.

If Congress were to try to uproot it entirely, I think that is going to take a real, real disaster this tax season, where things just do not work. Because it would require many of those, or it would require at least some of those, who voted for putting this bill in last year to now vote to uproot it this year. Because even though, you may say well the Democrats now control the House of Representatives. That is correct.

So, we could pass the House with no votes who voted for it.

But there is no way we are getting through the Senate, without at least some Senators saying: "You know I'd heard about the 20% deduction thing being simpler. But it wasn't really right, so we're going to go back." So, my guess on uprooting it: only if this is a total fiasco and we, in fact, get nothing filed.

And the bad news is: I suspect it will not be quite that bad. I think it will be having to deal with this crazy bit of 20% rules and special cases for the foreseeable future.

SURRAN: The IRS recently provided procedures under which a business may obtain automatic consent to change a method of accounting to comply with new code section 451(b). Essentially, this section – as amended by the Tax Cuts and Jobs Act – generally imposes a book/tax conformity rule for recognizing income for tax purposes. It provides that an accrual method taxpayer cannot treat the all-events test as being met for any item of gross income any later than when that item is taken into account as revenue in the entity’s financial statements.

The good news is that Revenue Procedure 2018-60 provides procedures for automatic changes for taxpayers to change their method of accounting to comply with the new section by filing IRS Form 3115. Even better news is that those businesses that comply with the automatic change procedures in the revenue procedure will receive audit protection.

WILLIAMS: Most viewers won’t be surprised: Ed Zollars predicts that a lot of businesses will be filing Form 3115 this year to change their method of accounting.

ZOLLARS: There are going to be a lot of Form 3115s filed this year – either because you are required to file them or you are allowed to file them. Now, here is the catch: if you have an applicable financial statement – which essentially means you file with the SEC, you have an audited statement, or you file any financial statement with a federal government agency. Or if the IRS decides to extend it, that could extend to the state government agencies – but again, that has not happened yet. But if you have that, you have to comply, so that you recognize revenue at least as quickly as you recognize revenue on that applicable financial statement.

Now, that is as a “heads-I-win, tails-you-lose” rule. If your financial statement for some aspects of what you do recognizes income more slowly than you do under tax, you still recognize tax the same way. If it recognizes it faster, you have to pick it up.

The IRS has given us automatic changes to allow for that. Plus, they also still have an automatic change if you want to try to go over to what is essentially ASC 606.
WILLIAMS: In addition, many of those tax accountants whose client/businesses are now changing their method of accounting may find themselves becoming more familiar with the book accounting rules in general and with ASC 606 in particular. As those tax pros are now learning, this new guidance on revenue recognition brings monumental changes to how many companies are going to account for revenue and how they will disclose revenue-related information.

ZOLLARS: Remember ASC 606 took effect in 2018 for public companies. It takes effect in 2019 for private companies, unless they elect to early adopt. But that means that, if you are a public company, then you are going to make your choice: do I want to try to go for ASC 606? Which, by the way, they do not guarantee that works for tax purposes. But if it does, you can get automatic changes, but you have to defend it yourself.

Or if you are a private company and you are not going to really adopt ASC 606, and you have an AFS, you almost certainly have a first year under ASC 605. ASC 605, we remember that as the way we always did revenue before. And your second year under ASC 606. So, you may have a second change in 2019 to comply with this structure. So, we have a couple of issues there. On top of that, we have three small business potential elective changes, actually four, I should say.

We have the ability, if you are under $25 million of average revenue for the prior 3 years, you can elect to go cash basis. You can elect to basically escape sec. 471 inventory rules, by either going to cash or going to what are essentially the supplies rules, which is non-incidental supplies. You can pick that up as your quasi inventory – or what you have on your books and records, so that is your option there.

We also have the ability to get out of sec. 263A, uniform capitalization, which – to be totally honest – I see no reason why one would ever stay with 263A if you did not have to. And then finally, if you are in the contracting business, you can actually, you can go to $25 million to be an electing small contractor, which would eliminate the requirement that you use the percentage of completion method.

But all four of those require you to file a Form 3115. The first three – the cash basis; the change in inventories; and the 263A rules – those all are basically a change in method with probably a negative adjustment, which means you get a deduction this year. That all comes in the current year – works great. If you do the contractor one, that one is a cut-off method – prospective only, so there is no 481(a) adjustment.

But nevertheless, you might want to consider those. So, yes, we are going to be filing a lot of Form 3115s, either because we have to, or there is an exception that gets us out for that making your financial year revenue as quickly as you do under the book basis. In some cases, a lot of people still have to file a Form 3115. Secondly, I expect a lot of people that look at that or be forced, they are going to say: “Wait, I prefer to go ASC 606 all the way.” In which, then, you are going to throw in Form 3115 electively. And those small businesses will look at this Form 3115. A lot of people are going to be doing Forms 3115 this year.

SURREN: States now have the authority to make online and out-of-state retailers collect sales taxes, the U.S. Supreme Court ruled last year in a milestone decision, marking e-commerce’s treatment as a mature player in a
marketplace that is no longer defined by trips to the corner store or the shopping mall.

Basically, the High Court closed a loophole that helped fuel the early growth of internet sales, overruling a half-century of its own precedents that forbid states from requiring merchants to collect sales tax unless those sellers maintain a “physical presence” within the state’s borders.

The case upholds South Dakota’s application of sales tax to businesses that sell into the state – such as Wayfair, as well as Overstock.com and Newegg – but have no property or employees in the state. The South Dakota law challenged the physical presence requirements for sales tax nexus, previously established by the Supreme Court in cases involving National Bellas Hess in 1967 and Quill Corporation in 1992.

Essentially, the Supreme Court decided that its own physical presence rule had become untenable, citing studies suggesting that the "artificial and anachronistic rule" now costs states up to thirty-four billion dollars annually in uncollected sales taxes, which has the dual impact of tapping the resources for public services, while distorting the marketplace by advantaging remote sellers over those anchored in the community.

WILLIAMS: Although the Wayfair decision dealt specifically with the issue of state sales and use taxes, Ed Zollars emphasizes that many businesses and their tax advisers should also focus on how states will now seek to collect income and gross receipt taxes from non-resident enterprises.

ZOLLARS: Wayfair will have a couple of impacts on us for 2019. The first key issue is there is a lot of speculation, and not just speculation, because Wells Fargo took a big charge against income shortly after Wayfair related to state income taxes. A lot of us are concerned that the states are going to get far more aggressive in pursuing state income tax claims against companies that have been operating in the state or have been selling into the state, but maybe not physically there.

We have seen cases. We already saw a case shortly, about the same time Wells Fargo came down, where Capital One lost a big case in Oregon, where they had no physical presence in the state of Oregon. But the state of Oregon still was asserting, and the Oregon Supreme Court allowed them to assess, an income tax against Capital One.

And Capital One’s only choices are: go to the U.S. Supreme Court or pay the tax. And the odds are, in this current environment, probably “pay the tax” is your choice. Because the idea is the Supreme Court approved Wayfair, what is the chance they are going to say the states cannot do it for income taxes?

So, you are going to have to probably review your exposure to states that you are not currently filing in, but which you have sales into, from an income tax perspective.

Just do not limit Wayfair necessarily to a sales tax consideration. Consider it is going to make the states more aggressive from an income tax standpoint.

WILLIAMS: Of course, many of our viewers recall what could be a significant precedent.

In 1959, after the U.S. Supreme Court decided the Northwestern States Portland Cement Company case on state taxation of interstate commerce,
the business community rallied to support the enactment of Public Law 86-272 by the U.S. Congress to overturn the High Court’s decision.

Yet, Ed Zollars does not believe that the current Congress would override the Supreme Court’s Wayfair decision in a similar fashion.

ZOLLARS: I have a feeling Congress is not likely to act in this area, because there is not unanimity in either party for a decision as to which way they should go.

The decision about whether we like Wayfair, or do not like Wayfair, depends much more heavily upon whether your state has – or do(es) not have – the sales tax.

Amazingly, representatives on both sides of the aisle from states – like, let's say, Oregon, Montana, New Hampshire – all decide that this whole thing needs to be clamped down. While those from states that – like South Dakota, California, and other locations – may decide that: “No, no, we need to expand this.”

So, there is a reason why the Supreme Court had to go back and make this decision on Wayfair, because Congress could not deal with it under Quill. My guess is: Congress will not deal with it here either.

So, the odds are that, whether you like it or not, the states are going to continue to jump on the bandwagon. And in fact, we need to be ready for the fact now, in 2019, state legislatures are coming back into session. And those states that could not easily comply with the Wayfair requirements, because of their laws back in 2018, are probably going to start passing bills in 2019 that will enable them to be able to go after and collect sales tax.

We are already at over 30 states that have enacted Wayfair-style provisions, either administratively or by law. Expect that number to go up where virtually every state that has a sales tax, by this year or next year, will have enacted rules to force out-of-state collection.

WILLIAMS: Interestingly, the Loscalzo Institute’s Ed Zollars was more optimistic that the states, with the blessing of the courts, might find a way for businesses to exceed the $10,000 limitation on the federal deduction of state and local taxes. He noted the initial success of Wisconsin’s so-called “work-around” that was championed by a Republican legislature and was signed into law by a Republican governor.

ZOLLARS: We are probably going to continue to see options and ways of trying to work around the $10,000 salt deduction. Interesting enough, most recently, the state of Wisconsin passed a special program that allows pass-through entities there to essentially opt-in to be treated for state tax purposes as a C corporation, which means that you will pass through the deduction on the K-1 for the federal return.

But you will not pay the taxes to the state of Wisconsin on your personal return. The idea there being: allowing us a deductible entity-level tax that we can take on the federal return.

That is an interesting second look at what Connecticut tried which, in Connecticut's case, would generate a credit. Now, the IRS has not yet really gone after that either: they are saying they do not like that. But the question is: if they don't like that, but they like Wisconsin.
Then, we will probably see Connecticut become like Wisconsin. And by
the way, if they like Wisconsin, we are going to see a whole lot more
Wisconsin-style statutes enacted around the country.

So, expect people to still become creative. By the way, I should note,
unlike the other states that have passed this, in Wisconsin this was signed
by a Republican governor – and not a Democratic governor. And by the
way, passed by a Republican legislature. So, what is interesting is: this
now is spilling over, not just to blue states, but red states are trying to
figure out workarounds.

The key takeaway at this point in time is be ready for changes and
answers. What we know today, as the answers around what we believe
are the answers right now. What we have in our guidance, at least some
of that is going to change. Some of it significantly, by the end of the year.
So, you need to be ready to adapt to the fact that you might have to
to change what you were planning to do based on guidance coming out
during 2019.

SURRAN: It’s a subject we’ve mentioned many times in the past: court cases or IRS
rulings where family members are pitted against each other, or against
their tax adviser, because a simple form was overlooked. Then,
everything becomes more expensive and the blame falls on anyone who
had a fingerprint on the IRA, the 401(k), or the insurance policy involved.

Essentially, those assets with beneficiary designations will not go through
probate and will transfer to the beneficiary at your death. They cannot be
redirected by any other means.

For example, if your will states that your IRA will go to your son, but the
beneficiary designation on the IRA account states your daughter, it will
go to your daughter. The most common assets with beneficiary
designations remain:

One, retirement accounts, whether IRAs or 401(k)s; Two, life insurance
contracts and annuities; Three, accounts that are payment on death or
transfer on death; and Four, all jointly held assets.

WILLIAMS: Over the years, we’ve stressed that a main component of estate planning
is designating heirs for your clients’ assets, whether it’s their stock
portfolio or their summer house.

Returning to our program is attorney Jeffrey Kolodny, a partner in the
Estate Planning and Administration Group of Kleinberg Kaplan. Over the
years, he has counselled our viewers that they should provide a regular
check-up of their clients’ beneficiary forms.

He reminds us, why that’s such an important step in tax and estate
planning.

KOLODNY: Well, people think, when they write a new will or they create a revocable
trust, that they are dealing with, and disposing of, all of their assets. But
that only governs the assets that are either in the trust or in the
individual’s estate. But that is not necessarily everything.

People could have joint accounts or other types of assets, like life
insurance, qualified plans, IRAs, 401(k)s. Those do not necessarily pass
under your estate. They pass by beneficiary designation form or by
contract.
And so, a life insurance policy or an IRA could be a very, very significant asset for someone that does not necessarily pass under their will. And so, you really have to review the forms to make sure that the assets are going to pass in a way that makes sense from the client's estate plan's point of view.

WILLIAMS: Yes, in general, reexamining those beneficiary designations does make sense. But Jeff Kolodny explains, why it’s so important to recheck the forms after a divorce or marital dissolution.

KOLODNY: So, when somebody gets divorced, generally they want to essentially write out or make sure that the divorcing spouse is not benefiting from their estate or their assets. And so, if you have somebody who is divorcing, I think it really makes a lot of sense: in that context – or maybe they are getting married or maybe they are having children – to review those beneficiary designation forms. It is very easy to change them, but it is often overlooked.

And people, if they are getting divorced, let's say: “They're not thinking about that.” And there are a lot of situations where it just falls by the wayside, and somebody does not put two and two together.

WILLIAMS: Let’s look at what could happen. Exactly one decade ago, in the landmark U.S. Supreme Court case of Kennedy versus Plan Administrator for DuPont Savings and Investment Plan, the justices ruled unanimously that a retirement account should be paid to the ex-wife – rather than to the daughter who was supposed to inherit a $402,000 401(k) account from her father.

Jeff Kolodny explains why the High Court wasn’t persuaded by the fact that the ex-wife had already waived her rights to the 401(k) account as part of the divorce settlement.

KOLODNY: That was a very interesting case. The first thing that the court held, when they were analyzing the issue, was that a waiver by a spouse in a divorce action is not the same thing as an assignment, a transfer or change in a beneficiary designation under a 401(k) plan that is governed by ERISA. The decedent, even though he had the right, and the spouse had waived her right to an interest in that 401(k) plan, he had never changed the beneficiary designation.

And so, when the daughter sued the plan administrator trying to recover the asset, the plan administrator was not wrong in paying those assets out to the surviving spouse.

And that is what the court held. If the decedent wanted to change that beneficiary designation form, he could have. And the plan is governed by what the beneficiary designation provides. He never changed it.

And there is a prime example, of why you want to review your documents in the event of a divorce, to make sure that your assets are going to pass the way you intend.

WILLIAMS: In recent years, 26 states have enacted so-called “revocation on divorce” laws based on a 1990 amendment to the Uniform Probate Code. Jeff Kolodny explains how these revocation laws affect who inherits assets from a decedent.

KOLODNY: So, these laws are actually a response to this very issue: that people do not necessarily think about retitling their assets or changing beneficiaries or changing their wills or life insurance policies in the event
of divorce. But the common or conventional wisdom is that people really will not want to benefit a spouse that they are divorcing.

So, the legislators have enacted laws that effectively provide that, depending on the circumstances.

But some states provide that if you have divorced a spouse and you have not changed your documents, your beneficiary designations, or your will, that your spouse is treated as predeceasing you for purposes of the bequest. So, it does protect individuals who do not make the changes to their documents. It has been a good development over time because, for most people, that is their desire. And a lot of these laws, by the way, have a provision where you could subsequently, if you did want to benefit a divorced spouse, you could provide another beneficiary designation that specifies that, and it would be respected.

SURRAN: The reason we’re discussing this topic this month is because of Mark Sveen’s insurance policy. He named his wife Kaye Melin as the primary beneficiary and designated his two children from a prior marriage as contingent beneficiaries to the policy.

Seven years after the divorce, Mark Sveen died – but he never changed his beneficiary designation form. But unlike the Kennedy case, the Minnesota state law removed the ex-spouse as his beneficiary and ordered that his two children should receive the insurance payment.

WILLIAMS: Jeff Kolodny explains, why the High Court didn’t just follow its own precedent from a decade ago and rule, once again, in favor of the ex-spouse.

KOLODNY: So, the facts here were a little bit different than the Kennedy case. You will recall that, in the Kennedy case, the court concluded that the waiver was not really a change in the beneficiary designation effectively. In this case, what happened was the individual got the insurance policy. After he designated the beneficiary, Minnesota enacted the revocation on divorce law, which does have the legal effect of essentially writing out the surviving spouse. The interesting part of the case was, because the law was enacted after he bought the policy and entered into the beneficiary designation and wrote it, whether that was unconstitutional to essentially provide that the assets go to the daughter and the spouse is written out. The court analyzed it.

They felt that it was a default rule, and it generally provided what most people would have done. And in fact, the decedent could have, as I said before, issued a new beneficiary designation in favor of the ex-spouse if he wanted to benefit that spouse. And so, the facts were a little bit different and the legal landscape was different. And that is why the court, I think, came out differently.

WILLIAMS: As you might expect, the ex-wife did argue that Mr. Sveen had ample opportunity over seven years after the divorce to change the beneficiary designation, if he really had wanted his children – rather than his ex-wife – to inherit the insurance policy.

KOLODNY: That is true, but this is exactly the reason why these laws are enacted – these revocations on divorce laws. Because most people feel that their children should “take” in that situation. The other thing is, and this really demonstrates, it is very important to make sure.
It is very simple to change your beneficiary designations and you should be thinking about this for your clients, so that their objectives are achieved.

It is not very difficult to do it and you can lock it up. I mean, there are two examples in these cases that went to the Supreme Court, where people just did not put two and two together and think about this issue.

WILLIAMS: You probably won’t be surprised. Jeffrey Kolodny restates what he told us at the outset of this discussion: checking a client’s beneficiary form is vital to any tax planning activity.

KOLODNY: For these reasons, it is very important for a tax advisor or an estate planner who is working with a client to revisit the beneficiary designations, even on an annual basis, just to make sure that the client’s circumstances have not changed in a way where they would want to make a change, because it is so often overlooked.

WILLIAMS: On the one hand, our viewers’ clients must file income tax returns, which usually means seeing their tax advisers on a regular basis. But on the other hand, most of them – even if they do want, and need, to change their beneficiary designations – are not rushing to rewrite their wills. So, we asked Kleinberg Kaplan’s Jeffrey Kolodny: unless these people are in ill health or in danger of dying, is there any rush? After all, don’t these clients have until 2026 to redo their estate plans in order to take advantage of the increased exemption amounts?

KOLODNY: Well that is a good point. But I think there is a good reason to consider planning right now. I mean, remember that a gift is taxed based on the value of the gift at the time of transfer. And if you have assets that you believe are going to appreciate, it is more tax efficient from a gift tax perspective to give those gifts away. Make those gifts when the value of the asset is lower, where you are using less exemption or maybe paying less tax.

So, as a result, you do not necessarily want to wait to make those gifts, and you may want to make them sooner rather than later.
Segment Three
3. Internal Auditing: Trends and Challenges

**Learning Objectives:**
Upon successful completion of this segment, you should be able to:
- Define the three main responsibilities of internal auditors;
- Identify the manual tasks of auditors that have been replaced by cognitive technology;
- Distinguish between sample-based testing and a population-testing process; and
- Explain how the background and skills of the internal audit workforce has changed in recent years.

**Segment Overview:**
While examining internal controls and financial statements is the responsibility of external auditors, internal auditing is an effective tool for keeping the enterprise performing at its highest level. As a result, internal auditors must be committed to delivering their message. We assembled a group of three high-level internal audit executives to address today’s challenges: Stephanie Johnson of JPMorgan Chase; David Lehmann of Protiviti; and Mark Martinelli of Synchrony.

**Field of Study:**
Auditing

**Expiration Date:**
July 7, 2020

**Course Level:**
Update

**Course Prerequisites:**
Work experience in financial reporting or auditing, or an introductory course in auditing.

**Advance Preparation:**
None

**Recommended Accreditation:**
1 hour group live
2 hours self-study

**Required Reading (Self-Study):**

**Video Transcript:**
See page 3–18.

**Running Time:**
33 minutes
Outline

I. Evolution of Internal Audit
   A. Responsibilities of Internal Auditors
      i. Monitor, analyze and assess organization’s risks and controls
      ii. Review compliance with government laws and policies
      iii. Provide assurance and recommendations to governing authority
   B. Instead of Checking if Process Is Operating, Auditors Evaluate
      i. Is this a critical process?
      ii. What risk is being presented?
      iii. How should we evaluate that risk?
   C. Focus of Internal Auditors
      i. Since Financial Crisis: on regulatory compliance
      ii. Continuing evaluation: efficiency and effectiveness of operations
      iii. Integrated audits: combine regulatory and operational compliance as well as financial controls

II. The Auditor and Auditing Career
   A. Looking for an Internal Audit Career
      i. Consider careers: risk control, governance and cybersecurity
      ii. Wanted: analytical individuals who want to continuously learn
      iii. Consider soft skills courses: ethics; culture; writing; effective challenge
   B. CPA = Internal Auditor?
      i. Lehmann: understanding of accounting and finance is great
      ii. Johnson: not as necessary as critical thinking and problem solving
      iii. Martinelli: must be committed to lifelong learning
   C. The New World of Internal Audit
      i. You can never have too much knowledge/experience on technology
      ii. Today’s students should be comfortable with data and digital technology
      iii. Even occupational certifications can be helpful in fast-changing areas
Outline (continued)

III. Technological Disruption in the Audit World

A. Cognitive Technology Replaces Manual Tasks for Auditors
   i. Counting inventories
   ii. Processing confirmation responses
   iii. Reviewing documents

B. Internal Audit Challenges from Technological Innovations
   i. Do we have the skill set to evaluate those changes?
   ii. How do we ensure that a new exposure is not being created?
   iii. How are we managing the risk?

C. Double Impact of Technology
   i. How internal auditing is done
   ii. What areas are being audited?
   iii. Result: auditors need technology skills to be effective at auditing

D. Change in Audit Methodology
   i. No longer relying on sample-based testing

IV. Advantages and Challenges of the Audit Profession

A. Advantages of Starting Career in Internal Auditing
   i. Exposure to all aspects of enterprise and its senior leadership
   ii. Develop understanding of risks and controls
   iii. Expand skills in communicating and reporting
   iv. Able to continuously learn

B. Be Prepared for Difficulties
   i. Pushback against being audited
   ii. Reality of time deadline
   iii. Need to “build” trust

C. Internal Audit Workforce
   i. Old: external auditors without business experience
   ii. New: people with business experience and data skills
   iii. Brand new: recruiting students who are trained in internal auditing

D. Good News about 15% Turnover
   i. Half of individuals departing internal audit transfer within same enterprise
   ii. Increasing number of recruits to internal audit from within organization
V. Alignment of Various Stakeholder Audit Expectations

A. How Do You Audit and Report on
   i. Strategic risks?
   ii. Cultural risks?
   iii. Environmental risks?
   iv. Social risks?

B. Audit Committee and Senior Leadership Need Reporting on
   i. Potential increase in strategic risk and in reputational risk
   ii. Understanding of emerging risks
   iii. Plan audits to drive more value

   “I think there is a bit more of that opportunity that we have, as internal audit, where we have the opportunity to think more forward: Could this happen to us? Are we set up to have the right controls?”
   — Stephanie Johnson

C. Communicating Audit Findings
   i. How can you convey findings in a concise electronic way?
   ii. Are we certain that areas of focus are being evaluated?
   iii. Does the audit committee know what we’re doing and how?

   “…there are very few professions that you actually have that latitude of being able to transfer and see so many different career paths and so many different industries.”
   — Mark Martinelli
3. Internal Auditing: Trends and Challenges

You may want to assign these discussion questions to individual participants before viewing the video segment.

1. According to our panelists, one of the goals of internal auditing is “to keep the enterprise and its employees at the top of their game.” To what extent is that a stated objective of your clients’ internal audit function? From your perspective, how successful is internal auditing in achieving that outcome?

2. All of the expert commentators note that it is increasingly common for internal auditors to transfer to other parts of the enterprise, and for workers in other parts of the organization to transfer into internal auditing. To what extent have you observed similar trends with your clients’ internal auditing organization? What impact is this trend likely to have on internal auditing and on the rest of the organization?

3. The internal auditors on the panel also note that technological innovations have substantially changed “how” they work and “on what” they work. Based on your and your clients’ experience, do you agree or disagree? From your and your clients' perspective, what is the impact of the new technology on internal auditing?

4. In recent programs, we have chronicled the requirement for external auditors to begin noting and disclosing critical audit matters that arise during their work. From the perspective of you and your clients, should the reporting of CAMs be extended to internal auditors? What is the potential “cost” to your clients, and what is the potential benefit?
5. According to recent surveys, most organizations have not adopted a formal enterprise risk management program. To what extent do your clients have a formal ERM program in place? To what extent is it based on COSO’s ERM framework?

6. According to our panelists, it is not uncommon for internal auditors and other financial executives to also serve as an organization’s risk officers. To what extent is risk management part of the duties of your clients’ financial managers? What benefits does this integration or separation provide to your clients? What risks or liabilities are there in this approach?

7. In recent years, we have featured – in conjunction with The CPA Journal – several panels of experts discussing issues of interest to financial executives. How do you feel about the use of this approach versus a single expert commentator? On what topics would you and your clients like us to assemble panels in the future?
Suggested Answers to Discussion Questions

3. Internal Auditing: Trends and Challenges

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   - Participant response is based on your practice and on your clients – their industry, their locations, their organization, and their compliance practices – as well as your perspective and experience.

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Suggested Answers to Discussion Questions (continued)

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- Participant response is based on your practice and on your clients – their industry, their locations, their organization, and their compliance practices – as well as on your perspective and experience.
Objective Questions

3. Internal Auditing: Trends and Challenges

You may want to use these objective questions to test knowledge and/or to generate further discussion; these questions are only for group live purposes. Most of these questions are based on the video segment, a few may be based on the required reading for self-study that starts on page 3–11.

1. What did Mark Martinelli refer to in his explanation of integrated audits?
   a) focus on financial controls
   b) combination of regulatory compliance and operational compliance
   c) cybersecurity and risk management
   d) automation and data analytics

2. Which of the following is an example of a soft skill needed to be an effective internal auditor?
   a) effective challenge
   b) data analytics
   c) operations
   d) economics

3. Which of the following was identified as a college minor aside from accounting that could be helpful to an internal audit candidate absent a dedicated auditing curriculum?
   a) sociology
   b) risk management
   c) data science
   d) mathematics

4. What was identified as a factor in demand being higher than supply for talented internal audit staff members?
   a) inadequate pay rates
   b) lack of people pursuing relevant college degrees
   c) skillset for auditors is transferable to different roles
   d) most talent is hired by the biggest 20-30 firms focused on financial auditing

5. According to Mark Martinelli, what is the turnover rate across the internal audit profession?
   a) 8%
   b) 15%
   c) 33%
   d) 50%

6. Which of the following was identified as a new type of risk that internal auditors are now starting to focus on as a byproduct of the others?
   a) financial risk
   b) compliance risk
   c) operational risk
   d) strategic risk

7. Internal auditors are generally accountable first to which group?
   a) senior management
   b) industry regulators
   c) external auditing firm
   d) audit committee

8. Which of the following represents the most important area of an internal control environment according to many internal auditors?
   a) authority
   b) processes
   c) people
   d) technology
### Objective Questions (continued)

9. Which of the following is correct regarding a continuous auditing program?
   - a) employs non-traditional skill sets
   - b) complex data analytics tools
   - c) large budget required
   - d) replaces traditional auditing

10. Which of the following is the first step towards starting a continuous auditing project?
   - a) understand the availability and structure of data in all business systems
   - b) define key operating metrics to be used for all assessments
   - c) develop a risk-based audit plan to align with the organization’s strategic objectives
   - d) identify critical business processes that should be subject to continuous auditing
Self-Study Option

Instructions for Segment

When taking a CPA Report segment on a self-study basis, an individual earns CPE credit by doing the following:

1. Viewing the video (approximately 30–35 minutes). The transcript of this video starts on page 3–18 of this guide.

2. Completing the Required Reading (approximately 25–30 minutes). The Required Reading for this segment starts below.

3. Completing the online steps (approximately 35–45 minutes). Please see pages iii to v at the beginning of this guide for instructions on completing these steps.

Required Reading (Self-Study)

THE TRANSFORMATION OF INTERNAL AUDITING

By Gaurav Kapoor of MetricStream Inc. and Michael Brozzetti, of Boundless LLC
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For additional info, go to: www.cpajournal.com

Challenges, Responsibilities, and Implementation

The field of internal auditing has transformed significantly over the past decade. Several factors have contributed to this change, including the increased complexity of a globalized marketplace, high-profile fraud and corruption scandals, new laws and regulations, and increased demand from stakeholders for greater assurance. Within the profession, internal auditing serves as a corporate conscience and guiding force that helps to ensure that business decisions and management operations remain consistent with an organization's mission, strategies, and goals.

Given the continually changing climate, auditors must take on additional responsibility to aid organizations in managing risk. Although internal auditing presents certain challenges, businesses should strive to implement an enterprise-wide internal audit system that takes advantage of the advice provided below.

Adding Value

The Institute of Internal Auditors (IIA) defines internal auditing as "an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes."

Internal auditors would do well to frequently revisit this definition and ask themselves several related questions: Is our internal audit department designed to add value? Are our internal audit processes systematic and disciplined enough to sustain that value? Are we willing to change areas that need change?
To truly add value to an organization's operations, internal auditing has to remain relevant to stakeholders, such as management and the board of directors. Internal auditors are the eyes and ears of the organization, and they can constructively improve the entity's risk management and internal control processes, while also providing assurances as to the effectiveness and efficiency of these processes and management operations. When properly designed, internal audit activities can significantly improve the business as a whole.

Emerging Concerns
Although internal auditors often report to management and the board of directors, they are generally accountable first to their company's audit committee. The following sections present some of the key concerns of audit committees that internal auditors should keep in mind.

- **Risk assurance and governance**: Although the focus on risk management has, for some time, been a key trend in the field of internal auditing, audit committees continue to consider it a major area of concern. The Institute of Internal Auditors (IIA) has issued guidance on how to provide internal audit opinions regarding the risk management, internal control, and governance activities of an organization by updating standards within its International Professional Practices Framework.

- **Enterprise risk management**: With enterprise risk management (ERM) becoming a top organizational priority, organizations' internal audit plans are being aligned with key enterprise risk areas to provide assurance that these risks are being managed effectively and kept in check by management.

- **Fraud**: Fraud has become a major area of concern for organizations worldwide. Internal auditors are being asked to assess and monitor fraud risks and controls, detect and investigate vulnerabilities, and provide advice on how to remedy these weaknesses.

- **Governmental regulation and reform**: The increasing complexity of compliance laws and regulations has prompted internal auditors to help track regulatory changes and compliance issues.

- **Aligning an organization's internal audit plan to its strategic plan**: Internal auditors can play a significant role in assessing strategic risks and guiding the expansion of business plans. They can also aid in the acquisition of a new company, the launch of new products and services, or the modification of a business' organizational structure to achieve operational excellence.

- **International Financial Reporting Standards**: Although U.S. Generally Accepted Accounting Principles (GAAP) remains the standard for U.S. businesses, there is a chance that International Financial Reporting Standards (IFRS) might become the standard at some point in the future. In general, IFRS requires increase transparency and greater disclosure around the methods and reasons for the accounting treatment of certain transactions.

- **Ethics**: Internal auditors are being called upon to help maintain a high standard of ethical behavior in their organizations by assessing the design and operation of third-party services; whistleblower policies; and ethics and compliance programs, including the handling of reported violations and subsequent disciplinary actions, when warranted.

- **IT security**: The move toward cloud computing, mobile computing, and virtualization have raised serious concerns about the security, integrity, and privacy of information. Internal auditors are being asked to audit these risks and the controls used to manage
them, while also getting involved in other GG areas, such as data analytics, disaster and data recovery, system access management, change management, and software development life cycles.

- **Doing more with less.** Risks might be infinite, but resources aren't. Thus, the task of improving risk and control management while also minimizing costs continues to be at the forefront of every internal auditor's mind.

- **Knowledge, skills, and abilities.** Given the growing importance of internal audits to the organization, much emphasis is being placed on the skills and qualifications required by auditors, as well as on their development, training, and retention. Many organizations are seeking a certified internal auditor (CIA) at the same time that many professional practitioners are pursuing the CIA designation as a means of demonstrating their internal auditing knowledge, skills, and competence.

### Challenges of Internal Auditing

The changing environment has created numerous challenges that internal auditors must face while performing their duties. The following sections highlight three of these issues.

1) **Coping with expanding responsibilities.** Today, internal auditors are not only asked to assess financial controls, but also to enhance governance, risk management, and control processes within an organization. Their responsibilities have expanded significantly to include strategy audits, ERM audits, ethics audits, operational audits, quality audits, GG audits, supplier audits, and due diligence in mergers and acquisitions. Internal auditors also have an obligation to understand how and why certain assumptions have or have not been made with respect to organizational strategy audits. For example, if an entity's management wants to launch a new product and assumes that it will get 20% of the market share within the first year, internal auditors need to question how such an assumption has been validated and how the organization might be impacted if those targets are not met.

2) **Managing information.** In order to add value to an organization, internal auditors need to efficiently integrate and disseminate information in various ways - vertically, with management and the board of directors, and horizontally, with other functions related to governance, risk, and compliance. Sharing information and intelligence with the right people at the right time is absolutely critical in decision making. In other words, information is only as good as the hands it gets into and the timeliness with which it gets there.

3) **Keeping pace with changing business risks.** The traditional model of creating an annual audit plan cannot be sustained any longer; in view of ever-changing business risks, internal audit plans need to be flexible. More importantly, internal auditors must prioritize pre-implementation activities over post-implementation activities when an organization undergoes transformational changes, such as establishing new goals, restructuring the enterprise, implementing management and personnel changes, engaging in mergers and acquisitions, and implementing new IT innovations.

### Implementing an Enterprise-wide Internal Audit Program

For an internal audit activity to be supported across an enterprise in an effective and sustainable manner, it must meet the objectives described below.

- **Act as a resource for risk information.** Internal auditors should present information and discoveries in a way that allows decision makers to make good choices. Auditors can't control the future, but they can help control the likelihood of future success by advocating sound risk management and internal control practices.
Balance a risk-based approach with an objective-driven approach. The traditional approach to risk management – listing out and managing hundreds of risks – is no longer an efficient one. With the growing need for better risk management policies and lower costs, there needs to be a stronger focus on key business objectives that set boundaries for risk assessment. This helps related activities remain relevant and manageable.

Get involved at the top. Internal auditors must collaborate with management and the board of directors to ensure that an organization's mission, strategy, and goals align with its purpose and values. They should ask relevant questions: Are the right people setting and approving strategy? Is the board providing risk oversight in the strategy planning process? Do the proposed strategies support the core values?

Maintain excellent talent. An internal audit department requires a balanced mix of internal recruits, external recruits, and third-party consultants. There should be an emphasis on training, including functional and industry certifications. In addition, the internal auditors' Code of Ethics includes the principles of integrity, competence, objectivity, and confidentiality, which must be followed by internal auditors and supported by management and the board of directors with unwavering conviction.

Prioritize people. Many internal auditors believe that people represent the most important area of an internal control environment. But when it comes to auditing, more time is usually spent on processes and technology than on people. If internal auditors want to save costs and manage risks more effectively, they must leverage an organization's people in the process and ensure that the right people have been placed in the right positions to do the right thing.

Utilizing Technology

Faced with multiple types of audits and increasing responsibilities, internal auditors can quickly find themselves overwhelmed. Fortunately, technology offers an advanced solution – it helps streamline and simplify audit processes, organize data, and automate time-consuming and resource-intensive workflows. The following sections address several ways that technology can enhance internal audits.

Integration. In a shift to simplify and improve the efficiency of internal audits, many companies opt for a single, integrated audit management platform. Such platforms extend across the enterprise, transcending business and functional silos, facilitating collaboration, and minimizing redundant processes and effort.

Audit workflows. An integrated audit management system helps streamline the complete internal audit life cycle and establishes the "systematic and disciplined approach" recommended by the DA that closely maps each business objective to various compliance areas, business and functional areas, processes, risks, and controls. The end result is a structured, organized, and value-driven approach to internal auditing, which is an essential part of the broader risk management concerns of an enterprise.

Risk assessments. Advanced audit management systems are usually equipped with a centralized repository or library of all the risks and controls that might affect an organization. This enables internal auditors to facilitate a targeted, risk-based internal audit that better supports business activities and key business objectives. Automated systems can help internal auditors save substantial time and effort in their risk assessment and tracking process.

Risk prioritization. Internal audit systems can support the quantification of relevant inherent risks and residual risks. They provide an aggregate view of an organization's risk profile,
enabling internal auditors to prioritize and plan their activities more effectively.

- **Resource management.** An integrated internal audit system allows internal auditors to efficiently plan and schedule audits for an entire enterprise and to deploy resources so that the most relevant and significant risks are addressed first. The system also helps standardize audit processes and methodologies for consistency in work quality; this, in turn, supports the quality assurance and improvement program required by the IIA.

- **Reporting.** Using a robust audit management system, internal auditors can efficiently organize audit data to support their recommendations and can gain management support for taking action. Some systems are equipped with powerful dashboards that provide real-time visibility into all the audit activities across the enterprise. This improves audit tracking and enables audit progress to be measured against key milestones for timely execution.

- **Continual monitoring.** Internal audit systems help automate the monitoring of risks and controls, provide alerts and warnings for risks that require attention, and track corrective actions recommended by internal auditors and implemented by management. Information from multiple audits can be aggregated and easily plotted on maps or graphs to track audit trends.

**Continuous Auditing?**

Big Data is powerful. It can also be daunting. The current data analytic landscape focuses on the use of "scripts" that can identify duplicates and quantitative outliers. Yet, there is little guidance for script implementation or use of existing resources.

Organizations are investing time and money in continuous auditing. However, success is limited to a few larger organizations with the resources needed to accomplish their implementation. For example, some companies have implemented continuous auditing processes for accounting functions, such as accounts payable (AP), which have added to their internal control structure and aided in Sarbanes-Oxley (SOX) readiness. These organizations have applied data analysis that alerts them to repeating check or invoice numbers, recurring and repetitive amounts, and the number of monthly transactions.

All of this is considered basic fraud prevention. The problem is that this ignores other risks and rarely provides value. Sometimes, a company spends thousands of dollars to implement these processes but does not get value from them. This article discusses the appropriate methods organizations should use in implementing continuous auditing procedures.

Companies don’t need complex data analytics tools or a large budget to employ an effective continuous auditing program. Organizations in the market for audit software can take advantage of a variety of tools. Those with little or nothing to spend can still achieve effective continuous auditing with simple yet powerful tools, such as Excel, and by thinking differently about data they already have.

**The Continuous Auditing Reasoning**

Internal auditing’s testing of controls is based on risk and often performed months after business activities have occurred. The testing is based on a sampling approach and includes reviews of policies, procedures, approvals, and reconciliations. Today, it is recognized that this approach affords internal auditors with a narrow scope of evaluation and is sometimes too late to be of real value to business performance or regulatory compliance. Continuous auditing is a method used to perform control and risk assessments automatically on a more frequent basis.

Continuous auditing focuses on testing for the prevalence of a risk and the effectiveness of a control. A framework and detailed procedures, along with technology, are key to enabling such an approach. Continuous auditing offers another way to understand...
risks and controls and enhances sampling from periodic reviews to ongoing testing.

Continuous auditing is not intended to replace traditional auditing but is rather to be used as a tool in implementing certain standard audit procedures to enhance audit methodology and effectiveness. For example, continuous auditing may occur by performing trend analysis on expense accounts to identify variances or drivers and alerting the audit team to a potential issue.

**Implementation Plan**

Implementing a continuous auditing model can be difficult at first. It is a process that grows as the maturity of the audit function grows. Initial project objectives are focused on developing a model and implementing processes to discover and analyze patterns, identify anomalies, and extract other useful information in data.

Start small with the development of the continuous auditing model and plan to expand your systems' capability as your understanding of the organization's data and underlying concepts grows.

After development, the next step is to align the continuous auditing model with internal audit's methodology and processes. Continuous auditing employs skill sets and resources that are different from traditional approaches; however, the methodology used to carry out the function is not significantly different. Continuous auditing is a function, like operational or IT audits, that helps internal audit management accomplish its objectives.

**Establishing Priority Areas**

Before starting a continuous auditing project, the following four steps need to occur:

1) **Identification of critical business processes that should be subject to continuous auditing.** These processes should be cross-referenced with an organization's top risks, as identified by leadership and enterprise risk management programs.

2) **Understanding the availability and structure of data.** A list of all business systems and the data available from those systems should be created. What systems have what reports available? For instance, if your company has a system for the storage and collection of HR data, it's likely that system has reporting capability beyond a list of employees and their contact information. The same is true of customer relationship management systems or IT systems. Internal audit will be far more valuable when it knows the value of these systems.

3) **Perform assessments based on risks using data, trending, ratios, etc.** For example, for a manufacturing company with factories in four states, inventory turnover might be a key metric. By using data analytics to examine variances in inventory turnover, it is likely that the reasons that a factory is underperforming could be pinpointed.

4) **Evaluate and assess the projected benefits of including the business cycle/area in the continuous auditing process.**

Most, if not all, internal audit departments have at their disposal a repository of risk and control information that details the processes and resources used (i.e., technology and people) by the organization to accomplish its objectives and goals. The information is revisited periodically and internal audit adjusts its audit plan based on new information. Continuous auditing will be used to initiate audit plan activities and increase internal audit coverage, and increase management's risk-based knowledge of the organization as data are collected, analyzed, and reported.

- **Enterprise risk assessment:** Most internal audit departments use a risk-based audit plan wherein the audit strategy is aligned with the organization's strategic objectives and goals using information from internal and external sources. Information is aggregated, and risks and controls are measured based on impact and likelihood. In some instances, this process is repeated at the operational
level before the initiation of an audit activity.

- **Audit activity plan:** The objective of internal audit is to provide management with timely assurance on critical or high-risk areas. Internal audit develops its plan to accomplish this; however, certain variables affect the plan:

  - **Resource allocation.** Internal audit allocates resources (i.e., people and technologies) based on the outcome of the enterprise risk assessment. Higher-risk items have more resources devoted to them.

  - **Plan changes.** Periodically, information is received or objectives change that cause internal audit to adjust the audit plan.

Like an enterprise risk assessment, the audit plan is constantly evolving and changing. Year 1 of implementation requires the creation of a perpetual inventory of current and future business information systems and the identification of external resources (e.g., management reports, financial analysis, etc.). Doing so may make implementation take longer, but it will allow for the process to mature much faster.

**A Multifaceted Role**

The current generation of internal auditors must strive to become as wise as an organization's board of directors, as savvy as an organization's management, as diligent as its accountants, as intelligent as statisticians, and as persuasive as attorneys. In other words, they must play a multifaceted role, while maintaining the highest levels of professional integrity in order to help their organizations avoid harmful risks and seize beneficial opportunities. It is not only a tall order but also a great responsibility. There is no doubt that audit competencies and skills will continue to be in high demand, especially as the HA endeavors to turn internal auditing into a universally recognized and accepted profession around the world.

There is no doubt that audit competencies and skills will continue to be in high demand.
3. Internal Auditing: Trends and Challenges

SURRAN: On the one hand, preparing reliable financial information is a key responsibility of the management of every enterprise. But on the other hand, to what extent should those same management and financial executives also be responsible for ensuring regulatory compliance, for evaluating company performance and for managing risk? Because of the potential for conflicts, it is the responsibility in most organizations of internal auditors to ensure that the enterprise has the ability to survive and to prosper in the competitive business environment by:

One, monitoring, analyzing and assessing the risks and controls of the organization;

Two, reviewing the organization's compliance with government laws and policies; and

Three, providing reassurances and recommendations to those with governing authority.

WILLIAMS: In other words, internal auditing on a periodic basis is an effective tool to keep an enterprise and all of its employees at the top of their game. On the one hand, internal auditors do maintain a relatively ironclad commitment to maintaining internal audit objectivity and to placing a priority on their assurance services over other activities. However, most internal audit organizations do find the time and the resources to pursue a relatively wide range of other advisory services. Along with The CPA Journal, we organized a panel of three experienced and articulate audit executives to explore the issues currently facing the internal audit profession:

Mark Martinelli, Chief Audit Executive for Synchrony;

Stephanie Johnson, Audit Senior Director at JPMorgan Chase; and

David Lehmann, Managing Director at Protiviti.

The trio began by noting how the profession of internal auditing, and how their own work, has changed in recent years.

MARTINELLI: I started in internal audit back in the 1980s. If you look at internal audit today versus back in the 1980s, it is unrecognizable. Internal audit was more a department you worked in, as opposed to a profession. What has happened – mostly post-Financial Crisis – is internal audit has become a profession in and of its own. We have the stature, and certainly a seat at the executive table. We have up-skilled and we are providing a lot more in-depth knowledge to management.

JOHNSON: My journey with internal audit started about 15 years ago. I would say one of the biggest things that has changed is the ability to think more critically about how processes are operating, versus checking a box and evaluating if a policy and procedure is being executed as intended. There is much more a focus now on evaluating the risk.

And understanding: Is this a critical process? What kind of risk is being presented to the firm? And how should we be evaluating that from an audit perspective?
Over the years, I have seen an increase of that critical thinking on risk management and of evaluation and feedback, versus checking a box to see if a process is operating as intended.

LEHMANN: Internal audit's traditional question is: are we controlling our risk in the areas where we have defined process and controls? Are those effective? It goes back to, as we increase the bar for internal audit going forward, the internal audit profession is in a good position to be able to look at things within an organization in a more aggregate manner in terms of the business risk that they are taking. Model that out a little bit and come to conclusions based on that. Traditionally that has not been something that we have asked of internal audit departments.

MARTINELLI: I think they have changed because there is a higher level of expectation that companies do the right thing. The right thing is not just what's legal. It is what is fair. I think when you add on top of that social expectations – "Occupy Wall Street" – there is a view of social law of what we should be doing.

In many ways, as auditors now, we are not just auditing the regulations, but we are auditing to the expectations that society has.

JOHNSON: There has been a shift in our workload. What I mean by that is we are focusing more on risk-based auditing, where we will evaluate more upfront where we want to spend most of our time, versus where we have looked to capture anything and everything.

WILLIAMS: Of course, many internal auditors must divide their time between – on the one hand, regulatory compliance – and on the other hand, efficiency and effectiveness of operations.

JOHNSON: Over the years, there absolutely has been an increase in our focus of regulatory compliance. Obviously, given the recent Financial Crisis and an increase in regulatory expectations with rules and laws, we have a requirement from an audit perspective to ensure we are managing our compliance with those regulations appropriately. However, with that, we still need to assess how effective we are doing our job as a firm. As an internal audit function, I think we have increased the regulatory review and our regulatory compliance. However, that is just to supplement also the work we already are doing, and continue to do, to evaluate the effectiveness and efficiencies of our operations.

They go hand-in-hand. Without looking at one, you may miss out on the real evaluation of the other.

LEHMANN: That gets to a little bit around the expectations of internal audit that organizations have and that boards and audit committees have. Again, I they want internal audit to do more than check-the-box traditional auditing. What I have seen change over the last 15 to 20 years in just what the content of audit reports and audit committee reporting is a greater emphasis on consultative advisory work.

MARTINELLI: Interestingly, what has happened is that we are doing more integrated audits. When we speak about integrated audits, it is a combination of regulatory compliance and operational compliance. The reality is the scrutiny that we have in our profession is that regulations in and of themselves are almost easy to follow. What is tougher is really to be able to address the expectations that the media have combined with governments.
LEHMANN: Regulation has driven a significant increase, I think, in the requirements of organizations to look at their risks and their controls – whether it is a risk management organization or an audit organization. Then, in terms of not only from a regulatory perspective, but trying to look at efficiency and effectiveness of operations, I think there: audit departments are recognizing a need to drive more value in the organizations and look at things beyond just what the regulations are requiring.

I think audit departments, now more than ever in an increasing way need to think beyond the regulations, need to think beyond just the controls. How are they adding value to the organization? How are they helping organizations drive efficiency and effectiveness?

MARTINELLI: External auditors focus on financial controls. That is their bread and breakfast. Internal audit will look selectively at financial controls. But we spend quite a bit of time looking at what we call operational compliance and regulatory controls as well.

We are looking more at financial controls now. Not necessarily at an entity level. I think there will be an increase at what we look at: at a segment level and at a product level. Again, the level of scrutiny that there are on operations, numbers and profitability has increased.

JOHNSON: We have the responsibility not only to look at financial controls, but beyond: What are the operational risk controls? How does the firm operate from a risk management perspective?

WILLIAMS: In other situations, the internal audit department is also expected to oversee the company's risk management, corporate governance and business improvement processes.

MARTINELLI: Companies change and transform in different ways. They might get a new management team. They might be acquired. They might acquire a different company.

The way you audited a company today has to continually transform.

One of the challenges we have at internal audit, and I think one of the things that makes internal audit interesting, is being able to adapt to that change.

LEHMANN: The need for oversight, governance, risk control, risk management – again, I think largely driven from the financial services regulatory environment – is growing. From that perspective, there is just a huge competition for people. I think there is effectively a shortage.

I advise people to – young folks who are thinking about different career paths to – really consider risk control, internal audit governance, cybersecurity-type careers.

Because I think that that is, again, going to just continue to explode and the demand is not going anywhere.

JOHNSON: We are looking for critical thinkers. We are looking for analytical individuals. We are looking for those individuals that want to continuously learn. That is just foundational.

Then, we think about layering some expertise – whether it be model risk, IT risk, data, or even specific to industry.

MARTINELLI: I know often, when I mentor students at different universities, they always ask, "What's the additional class I should take? Is it a new finance class? Is it something in derivatives?" And I tell them that you need to take
courses in understanding ethics, understanding culture, understanding how to become a better writer. We mention soft skills.

Universities are not necessarily trained to develop your soft skills. To be an effective auditor, you need an ability of having good levels of soft skills. Skills related to influencing, skills related to effective challenge. Effective challenge is part of the underlying core that is needed to be independent and objective. And I think these are the types of courses and workshops that, if I was considering going into accounting and internal audit, I would look into.

LEHMANN: When I think about skill sets, of course, I think about technology and the things that we need. In addition to that, even on the process side or the financial accounting side – you need to have skills in the technology space. In terms of what we are looking for in candidates, I think we are looking beyond. Again, accounting degrees are great. Being a CPA, I value someone that comes in with an understanding of accounting and finance.

JOHNSON: I hire individuals that have a CPA. I do not have one. What I do have is an undergraduate degree in economics. That taught me how to critically think. That taught me how to problem solve. It required me to think in a more macro-perspective.

When I think about college hires, I want them to think about the opportunities, like: What are the skills that they are learning in the classroom that they can transfer into the workforce? We will teach you internal audit. We will teach you how we need to think about risk and controls. But are you going to ask the questions? Are you going to be inquisitive? Are you going to work hard? Are you going to roll up your sleeves to really understand how a place operates and how a process works end-to-end?

Then, how are you going to then translate that to communicate what you are learning and what you are seeing?

MARTINELLI: We also have to introduce what I call lifelong learning. Lifelong learning in terms of supporting training sessions outside of your company and internal to your company. And make sure, again, that we are keeping the skills that those individuals have honed. So, hiring the best individuals, and keeping them well trained.

JOHNSON: I think one of the things is just staying engaged. I think there are opportunities. We have a number of industry groups that we can participate in: conferences; training opportunities.

It is just learning and building your network, and understanding who else is in your world and who is in your sphere and what you do.

LEHMANN: We are looking for, a lot of times, people with MIS degrees, cyber security degrees, other types, even engineering type degrees, that bring a different type of logical thinking and problem solving and comfort with technology. Again, I would apply that across different disciplines within our firm and within internal audit.

You can never have, I think, nowadays too much focus and too much knowledge and experience when it comes to technology. I think that continues to be the biggest driver of change in what we are looking for in candidates.
MARTINELLI: My advice for young students considering going into internal audit or accounting would be as follows. We are still in early days of universities having a dedicated curriculum for internal auditor. I think there are several. Even if you go to a university that does not have a dedicated internal audit curriculum, I think one of the things that I would do is, aside from taking the accounting and finance classes, I think I would dedicate a significant amount of my time of getting certainly a minor, if not a master's degree, in data.

I think the data science, the ability of auditing digital, the ability of understanding what digital is and understanding technology, I think is a must.

It is going to be transformative and it is going to provide an exponential change in what we do, and how we do it, in internal audit.

JOHNSON: From my perspective, I obtained my certification in anti-money laundering.

So, the CAMS certification: understanding the rules and regulations around AMLs an example. Other parts of the industry are looking for similar individuals that have that control mindedness. So, the demand for those types of talent – the top talent – is high.

LEHMANN: Find ways to take some courses that give you a technology background and understanding. Get comfortable with technology. Because no matter what you do coming out of school, that is going to be a really key element. I would advise people who are still getting an education to think about internal audit.

SURRAN: Like any profession, internal auditors are not immune to change and disruption. Not only is there increased oversight, but – as you have heard – the expectations of senior executives and of the public are changing rapidly. But what role will technology play in the changing world of internal auditors?

In general, technologies – such as cognitive technology – can enable internal auditors, as well as accountants, to automate tasks that have been conducted manually for decades, such as counting inventories or processing confirmation responses.

As a result, auditors can be freed up to focus on enhancing quality by evaluating advanced analytics, spending more time exercising their professional judgment, and providing greater insights. For instance, reading through stacks of contracts to extract key terms has traditionally been a time-consuming, as well as a manual, process.

Internal auditors are increasingly taking advantage of cognitive technologies, including so-called natural language processing, to largely automate the process of document review.

WILLIAMS: In that context, our three panel members emphasize how technology has changed what is being audited as well as how it is being audited.

MARTINELLI: I think, first and foremost, it is the disruption that is taking place because of technology. If you look at what is happening: with the cloud; with mobile; with cybersecurity; and with data. Those are all things that are new emerging risks that need to be audited. They have never been audited before. They were not really risks before.

JOHNSON: There are so many opportunities of how we can do things quicker, be more efficient, and just have this life be easier for you from a day-to-day perspective. The challenge from an internal audit perspective is: how do
you stay on pace with change? Because when these new innovations happen: Do we have the skill set to evaluate those changes, those new products, those new initiatives? How do we ensure that this is not creating new exposure for us as a firm? How are we managing that risk? That is one of the biggest challenges.

LEHMANN: I think one of the big things that has changed, and others have mentioned it, is technology and innovation in the technology space.

And how that is affecting in two dimensions: How we are auditing; and What we are auditing. From a how perspective, again, no more binders. We are electronic now.

Not only is our audit work performed internal – and largely external audit, too – on electronic format. But we are using technology to enhance how we are auditing. Using data analytics, using automation in that.

MARTINELLI: One of the biggest challenges is: How do you take these new and emerging risks, new and emerging technologies and train individuals in order to be capable of auditing in them? Some of that you can do with training. Some is new and un-ventured territory. Take data. How do you audit data? Data frameworks – how data is transferred?

LEHMANN: Then, what we are auditing has changed significantly as well. We are no longer looking just at a ledger. And others have mentioned the clipboard-style auditing and that type of thing. Now the surface area from a technology perspective has expanded. You cannot extract technology from a business process anymore. What we are auditing has changed significantly as well.

And now, auditors really need technology skills and technology competencies to really be effective at auditing, no matter what you are auditing.

Even down to the things that external auditors look at most frequently, which is internal control over financial reporting.

JOHNSON: A lot of our auditing I did 15 years ago was sample-based testing. Now, what we are looking to do is be more population-testing. What does that mean?

We need to get lots of data. We need to evaluate how that data is being obtained, and what is the criteria to evaluate the effectiveness of our processes.

We are getting more data scientists, and data analytics-focused, so that we can be much more deeper in our audit work and evaluate how things are operating in a bit more holistic way. Versus where maybe in the past we would do sampling and there would be some sampling risk that would be created. We are reducing that risk with some of our work today.

LEHMANN: Cybersecurity is something that no internal audit department can ignore. I think every chief audit executive would shake their head 'yes' to that. While internal security organizations are, and have to, manage it closely and do their own assessments, internal audit needs to have its own perspective on what cyber security risk means to that organization and really be focused on developing an independent view of cyber security.

MARTINELLI: I mention the war on talent, which creates another challenge: that we have an audit plan that we need to be able to execute on every year. You add on top of that the emerging technologies and changes that are taking place.
WILLIAMS: In terms of challenges, the panel members tended to emphasize the human nature of an enterprise, whether it's the need for overcoming staff cynicism or the need to develop an acceptable comfort level.

MARTINELLI: I think the best parts of working as an internal auditor, at a very young age or an early part of your career, is you will be exposed to all the operations, controls, and areas that that company does – which is really rare for someone to do early on in their career. To be able to see both the revenue side, the operational side, the risk side, the business side. Exposure to very senior individuals.

I think it hones their skills at a very, very young age. It gives them broad experience to the overall organization. Equally, as I mentioned before, it is a training ground. It is a training ground to be able to go into a variety of different areas. You can have a career in internal audit or ultimately you can transfer into the business.

I think you develop a very good understanding of risks and controls, good communicating skills, and reporting skills.

JOHNSON: I think this organization that I am in gives me the opportunity to see many things – both domestically and globally. I think, as an internal auditor, you have the opportunity to ask as many questions as you want.

The best thing I find about my job is that I am always learning. I am always asking questions. Then, I am thinking about: Does this make sense? Is this management decision the right decision for us as a firm? Is it creating risk? Are we managing those risks in a controlled manner? Those things are the fun part of the job. You are really critically thinking and asking tons of questions to get there.

LEHMANN: The best part of my job is being able to solve problems for my clients.

I think, there is an execution element to what I do, for sure.

I think sitting down with a client, maybe that I have had a relationship for a long time or a new client, and hearing a new problem and being able to have the solution for that client is very rewarding.

MARTINELLI: There is that level of responsibility of the power that comes that you have with internal auditors that are reporting to auditing committees. What are some of the negatives with that?

You are going to get a level of pushback. No one likes to be audited and yet they understand the importance of being audited. Some of the negatives and challenges are: there are time deadlines.

In any given company, you have an audit plan. You have to execute on that audit plan. Deliver on it. You have to balance the objectivity that you have of reporting items you find, with the fairness of reporting them in the right way. That becomes challenging early on in your career.

JOHNSON: The tough part of the job, though, is building the trust from others that you are here to help, and that you are here to help the firm ensure that we have a sound practice.

Building trust sometimes can be difficult, especially for individuals that know that you do not have the knowledge or business knowledge. So, you have to overcome that.

WILLIAMS: Of course, in many organizations, there are issues about the supply of, and demand for, talented staff members, especially during a time when there is often a so-called war on talent.
MARTINELLI: There is a war on talent. Talented individuals are difficult to find.

JOHNSON: I think talent demand is high. I think the skill set for auditors is transferable to different roles.

LEHMANN: In a sense, there is a shortage, but it is not because there is a lack of people pursuing relevant degrees. I think the reason it is challenging, and many believe that we are in a war for talent: there is a lot of demand out there and not enough candidates. It is more on the demand side than the supply side. I think, again, the industry is growing.

MARTINELLI: I think over the years the size of the staff has essentially stayed the same. But what has happened is the composition of the staff has changed. What I mean by that, if you went back and not even that many years ago, pre-Financial Crisis.

Most of your team would have been traditional auditors, trained as external auditors, who have become internal auditors. They did not have business experience.

JOHNSON: Where we may have had historically more accounting professionals in our audit department, we have now a much more diverse group of individuals with different business background and experiences who are at the table as internal auditors to evaluate the effectiveness of the firm and our risk management practices.

MARTINELLI: If you look at most internal audit departments now, a significant composition of the team will have non-audit experience. What do I mean by that? They have been treasurers, traders. They have worked in operations.

There has also been a tremendous amount of up-skilling, which has been required because of the nature of the risk that we are trying to audit. Model risk, data scientist, more individuals that have a digital background.

So, the number itself has stayed the same. The composition, the technical skills they need, and the soft skills they need have been significantly enhanced.

JOHNSON: From the changes that I have been seeing, it is a combination of where we have individuals that have business knowledge, where they are in the industry – whether it be as a trader, a portfolio manager, to an operations manager. To individuals that have very specific skills and technology that we are augmenting our staff to make sure that we are thinking about the new risks that are entering our industry.

MARTINELLI: Traditionally, we had done most of our hiring from external audit firms: big firms, the big 20-30 firms that focused on financial auditing. What has changed and transformed now is we are doing much more operational and compliance work. The up-skilling is: "Look, there is a tremendous need for individuals that can use data."

Now, we have colleges and universities training individuals to be internal auditors. So, you are getting the technical skills of understanding what controls are, what internal control frameworks are, and what risk is.

LEHMANN: It is challenging to find the good people. We have a strategy that includes hiring directly from industry, hiring from professional services firms and hiring off campus. I think we are very, very selective. We always have open needs. We will not hire anyone that does not meet our standard. I
think finding the good people is really challenging. Unfortunately, we have not found the silver bullet. It is just elbow grease.

**MARTINELLI:** We are certainly always recruiting. We are recruiting by going to different networking events, trying to identify who the best people are.

Keeping in mind that companies have gotten very good at taking their more talented staff and treating them well – both in terms of the work environment, and how they are compensated, talent management. You add on the millennial effect. And it is a challenge.

**JOHNSON:** Teaching individuals, what does it mean to be in internal audit. Having those sessions, so that they can learn more about the firm and more about what we do as a profession. I think it is important to continuously be out there, involved in the communities and be able to have an opportunity for people to ask you questions.

And so, sometimes, what they do not know is because they have not asked the question.

They may not exactly know that internal audit is a fit for them.

**WILLIAMS:** As you might expect, the exchange of talent with other groups in the enterprise can build, and reinforce, the relationship of those units with the internal audit staff.

**MARTINELLI:** On average, across the internal audit profession, you have about a 15% turnover rate. Half of that, the good news, is that those individuals are transferring into the organization they work for, which is a good thing. Internal audit departments have become a conduit to find good staff. We still have to replace those 15%.

**JOHNSON:** I sometimes lose my top talent to other firms or internally, which I think is great from a growth perspective. But at the same time, that makes my job a little bit harder to continue to recruit and hire and search for that talent.

**LEHMANN:** In the consulting business, there is, as you can imagine, a significant level of competition for the talent that we employ.

**MARTINELLI:** I mentioned that internal audit departments have become providers of talent within the organization that those internal auditors work. Equally, we are also trying to get individuals that are not in the audit function. They might be in the risk function, in the credit function, or in operational functions to get them to come into audit. How are we doing that?

I think we are doing a much better job with branding: describing what internal audit is; the career of internal audit. We do it through rotational programs. We do it through guest auditor programs. That is internal to the organizations we work for.

**WILLIAMS:** Of course, the use of technological innovation has also sparked a new level of engagement on the part of outside stakeholders – from investor groups to regulators. The panel addressed the need to maintain the alignment of various stakeholder expectations of internal auditing.

**MARTINELLI:** Traditionally, internal auditors looked at financial risk, compliance risk, and operational risk. Some of the risks that we are now looking at, more in the way of byproduct, are: strategic risks, cultural risks, environmental risks, and social risks. The challenge we have is: How do you audit those? And then, how you would actually report on them?
We are now looking at those reports on an aggregate basis to see if, overall, there is an indication from the results of the work that we are doing in operations and controls and finance – to see if, collectively, strategic risk is increasing or reputational risk is increasing for that firm. It is an area I think that we are expanding what we are doing on. It is still a bit of untested waters. Really, what boards and what stakeholders and regulators are looking for us to do is give more of our opinions on what we are seeing.

JOHNSON: I think a significant responsibility for internal audit is to give a look back at how we are operating. There is the evaluation of the controls and the existing control environment. To be able to provide that feedback to the audit committee and to the board and senior leadership. However, I think, as we continue to evolve, and as the businesses, especially in the financial services industry, there is an aspect of also understanding: what are the emerging risks? What can we learn from others in the industry? Applying those lessons learned from an internal audit lens, assess: what does that risk really mean for our organization? I think there is a bit more of that opportunity that we have, as internal audit, where we have the opportunity to think more forward: Could this happen to us? Are we set up to have the right controls? And evaluating that ahead of a problem actually occurring.

MARTINELLI: With that seat at the table that we get, there is a higher expectation of us being able to execute on the work that we have been charged to do. Does that mean finding everything? No. But there is a requirement and expectation – by the stockholders, by the shareholders, by our regulators, by management – that, once we have executed an audit, we found most of the significant items. That responsibility is not a small responsibility. It does create a level of stress and strain of making sure if what we are executing is correct.

LEHMANN: I have noticed that the expectations for internal audit and chief audit executives: the bar is going up. What I mean by that is the expectation for internal audit to be doing more than: check the box; control test; test result; what is the effectiveness of that area?

They want internal audit to be driving more value. I think that requires internal audit departments to rethink the way they plan their audit plans. And how they allocate their budgets and the type of people they are hiring. They have to raise the bar there. That makes for a particular challenge.

MARTINELLI: Traditionally, we have issued audit reports. Whether they were on paper or now they might be electronically, it is a 15-page audit report. In today's day and age, can we expect somebody on an iPhone or on an iPad to read a 15-page report? Again, we have to be able to adapt and transform the thinking that we have. One of the things we are looking at now is:

How do we take our audit findings and communicate them electronically in a concise way that conveys the message we want to be able to convey, while being able to give the level of detail that we want?

JOHNSON: We are always working on: How can we communicate our findings in the most succinct manner?

I challenge my team and myself to ensure that we are really thinking about what are the areas of focus and ensuring that those areas that we are going to be evaluating is the valuable feedback that we are going to have at the end of the reporting.
Otherwise, the output of the report will not be necessarily as valuable for the senior leadership.

MARTINELLI: The other thing to is making sure you have a supportive audit committee, audit committee chair, and management.

You want to make sure that they understand what you are doing and how you are doing it. One of the most significant powers we have as internal auditors is that we are independent.

What does that mean? It means we work for the company, but our reporting line is directly to the chairman of the audit committee. That is a very powerful thing.

WILLIAMS: Perhaps not surprisingly in an auditing program, there is a bottom line. Each of the panel members believes that recent innovations have the potential to improve the quality, while reducing the costs, of the internal auditing profession.

MARTINELLI: I think between the emerging technologies, effective new and emerging risk, the war on talent, and the expectations, those are some of the higher-level challenges we face as an internal audit profession.

JOHNSON: What keeps me here is the opportunity to continue to be able to influence and provide feedback to leadership and ensure that we are managing our firm's risk appropriately. But then, the other part is just also having a little bit of fun.

LEHMANN: I think for people that really want to be challenged, and be given opportunity that will allow them to make the best choice for their own careers, I think this is a great profession to be in.

MARTINELLI: If you think about it, there are very few professions that you actually have that latitude of being able to transfer and see so many different career paths and so many different industries. I would highly recommend it to individuals that are starting their careers.
Segment Four
4. Managing Your Risk: Tenets of Derivatives

Learning Objectives:
Upon successful completion of this segment, you should be able to:
- Recognize the role that derivatives play in managing risk;
- Identify the main types of derivative instruments;
- Recognize the implications of FASB ASU 2017-12 on hedge accounting; and
- Identify the major differences between the old and new rules for hedge accounting.

Segment Overview:
There is little doubt that derivative instruments can mitigate risks, particularly for those enterprises where uncertainty is undesirable. But many businesses often resist the use of derivatives, especially since hedge accounting has been a complex aspect of financial reporting. Dr. Ira Kawaller, the founder of Derivatives Litigation Services, focuses on why and how these instruments can aid in managing enterprise risk and provides an update of the latest hedge accounting rules.

Field of Study:
Accounting

Expiration Date:
July 7, 2020

Course Level:
Update

Course Prerequisites:
Work experience in financial reporting or accounting, or an introductory course in accounting.

Advance Preparation:
None

Recommended Accreditation:
1 hour group live
2 hours self-study

Required Reading (Self-Study):
“Ten Tenets of Derivatives”
By Dr. Ira G. Kawaller, Founder, Derivatives Litigation Services
For additional info, go to: www.derivativeslitigation.com

“FASB Issues Standard Bringing Targeted Improvements to Hedge Accounting”
By Mark Bolton, Denis Rolfes, Casey Fersch, and Jon Howard, Deloitte & Touche LLP
Excerpted with permission of Deloitte US
For complete report, go to: https://www2.deloitte.com/us/en.html

See page 4–9.

Video Transcript:
See page 4–16.

Running Time:
38 minutes
I. Derivative Purposes
   A. Derivatives Help You Address Risks
      i. Price
      ii. Interest rates
      iii. Foreign currency
   B. Derivatives Decrease Risk with
      i. Interest rates
      ii. Foreign currency
      iii. Materials/commodities
      iv. Credit/default risk

II. Using Derivatives Successfully
   A. Why You Use Derivatives?
      i. You’ve identified an exposure
      ii. Helps to offset a loss on your normal exposure
      iii. Establish boundary conditions on performance
   B. Can You Use a Derivative for What’s Already Taken Place?
      i. No – Once you’ve incurred the loss, it’s over
   C. The Manager’s Dilemma
      i. Is the price movement a new trend in that direction?
      ii. Or is the price movement going to reverse?
      iii. There is no way to know for sure

III. Derivative Types
   A. Main Types of Derivative Instruments
      i. Forward-type
      ii. Option-type
   B. Forward-Type Derivative
      i. Locked in at the price the “consensus market” views what people expect to be paying in the future
      ii. There is an opportunity cost in the event the price goes lower
   C. Option-Type Derivative
      i. Fixed cost payment that serves as insurance
      ii. They involve cost, but they’re fair
   D. Option Pricing Depends on Market Consensus Views on
      i. How volatile the price is
      ii. How likely it is that the price can change dramatically
Outline (continued)

IV. Closer Examination of Hedge Coverage

A. Natural Hedge
   i. Buying and selling in the same foreign currency
   ii. Exposure is only the net difference
   iii. Address the net difference with derivatives

B. Hedge Coverage Example
   i. 100 units of exposure
   ii. Start by hedging 50% of the risk
   iii. As time goes by with more information
       • Higher probability of risk: increase the hedge
       • Lower probability of risk: reduce the hedge

V. Importance of Hedge Oversight and Audit Coverage

A. Derivatives Decrease Risk with
   i. Interest rates
   ii. Foreign currency
   iii. Materials/commodities
   iv. Credit/default risk

   “The idea of not treating these risks in a serious and thoughtful and disciplined manner seems to me to be an abrogation of fiduciary responsibility.”

   — Ira Kawaller

B. Enterprises That Utilize Derivatives Must
   i. Assure that knowledge of tools is shared
   ii. Assure that oversight is accomplished through audits
VI. Regulatory Approach to Hedging

A. FASB ASU 2017-12
   i. Simplify hedge accounting treatment
   ii. Reflect economic results of hedging in financial statements
   iii. Align accounting rules with risk management activities

B. Kawaller’s Observation
   i. For public companies having concurrent earnings recognition of the hedged item should be a high priority
   ii. Whether you qualify for hedge accounting or not, there are explicit disclosure requirements

C. New FASB Standard on Hedge Accounting
   i. Hedges still need to be documented
   ii. The question of effectiveness still needs to be addressed
   iii. Accounting rules have been simplified

D. New FASB Standard on Hedge Accounting: Commodity Hedges
   i. Old rules
      • Derivative had to offset entire commodity price exposure, including adders or adjustments
   ii. New rules
      • You can hedge just the external price

E. Kawaller’s Perspectives on Hedge Accounting
   i. Old rules: More often than not, people failed due to the design of the effectiveness test
   ii. New rules: Make it easier for people not to be tripped up by tests that did not turn out right
Group Live Option

Instructions for Segment

For additional information concerning CPE requirements, see page vi of this guide.

- As the Discussion Leader, you should introduce this video segment with words similar to the following:
  “In this segment, Dr. Ira Kawaller focuses on why and how derivative instruments can aid in managing enterprise risk and provides an update of the latest hedge accounting rules.”
- Show Segment 4. The transcript of this video starts on page 4–16 of this guide.
- After playing the video, use the questions provided or ones you have developed to generate discussion. The answers to our discussion questions are on page 4–6. Additional objective questions are on pages 4–7 and 4–8.
- After the discussion, complete the evaluation form on page A–1.

Discussion Questions

4. Managing Your Risk: Tenets of Derivatives

You may want to assign these discussion questions to individual participants before viewing the video segment.

1. Why do organizations use derivatives? What is your and your clients' experience with derivatives?

2. What are the main types of derivative instruments?

3. What are the major characteristics of forward-type and option-type derivatives?

4. What is a natural hedge? What is your clients' experience with natural hedges?

5. What does Mr. Kawaller suggest that companies that utilize derivatives do? Do your clients do that? If so, how? If not, why not?

6. What are the implications of FASB ASU 2017-12?

7. What are the differences related to commodity hedges under the old and new rules?
4. Managing Your Risk: Tenets of Derivatives

1. Why do organizations use derivatives? What is your and your clients' experience with derivatives?
   - Why You Use Derivatives
     - You’ve identified an exposure
     - Helps to offset a loss on your normal exposure
     - Establish boundary conditions on performance
   - Derivatives Decrease Risk with
     - Interest rates
     - Foreign currency
     - Materials/commodities
     - Credit/default risk
   - Based on your and your clients' experience

2. What are the main types of derivative instruments?
   - Main Types of Derivative Instruments
     - Forward-type
     - Option-type

3. What are the major characteristics of forward-type and option-type derivatives?
   - Forward-Type Derivative
     - Locked in at the price the “consensus market” views what people expect to be paying in the future
     - There is an opportunity cost in the event the price goes lower
   - Option-Type Derivative
     - Fixed cost payment that serves as insurance
     - They involve cost, but they’re fair

4. What is a natural hedge? What is your clients' experience with natural hedges?
   - Natural Hedge
     - Buying and selling in the same foreign currency
     - Exposure is only the net difference
     - Address the net difference with derivatives
   - Based on your clients

5. What does Mr. Kawaller suggest that companies that utilize derivatives do? Do your clients do that? If so, how? If not, why not?
   - Enterprises That Utilize Derivatives Must
     1) Assure that knowledge of tools is shared
     2) Assure that oversight is accomplished through audits
   - Based on your clients

6. What are the implications of FASB ASU 2017-12?
   - FASB ASU 2017-12
     1) Simplify hedge accounting treatment
     2) Reflect economic results of hedging in financial statements
     3) Align accounting rules with risk management activities

7. What are the differences related to commodity hedges under the old and new rules?
   - New FASB Standard on Hedge Accounting: Commodity Hedges
     - Old rules
       - Derivative had to offset entire commodity price exposure, including adders or adjustments
     - New rules
       - You can hedge just the external price
Objective Questions

4. Managing Your Risk: Tenets of Derivatives

You may want to use these objective questions to test knowledge and/or to generate further discussion; these questions are only for group live purposes. Most of these questions are based on the video segment, a few may be based on the required reading for self-study that starts on page 4–9.

1. According to Ira Kawaller, what is the objective for using derivatives for risk management?
   a) establishing limits or boundary conditions on performance
   b) generating gains from using derivative positions
   c) creation of competitive advantages
   d) forecasting market trends

2. Which of the following is correct about the use of forward-type derivatives to lock in a commodity's price?
   a) the purchaser of the contract is locking in the current price of the underlying commodity
   b) there is no opportunity cost if the price of the commodity falls lower than expected
   c) some contracts are entered into on the basis that one side may have an advantage over the other at inception
   d) there are no direct payments at the onset of the contract

3. Which of the following represents an example of a natural hedge?
   a) farmers selling wheat and bakers buying wheat
   b) futures contract
   c) importing and exporting in the same country with comparable volume
   d) interest rate swap

4. Which of the following is correct about hedge accounting according to Ira Kawaller?
   a) qualifying for hedge accounting is a low priority for public companies
   b) it is the preferred treatment for entities to try to qualify for hedge accounting
   c) it is a requirement for entities who use derivatives to hedge
   d) it separates the recognition of gains and losses on the item being hedged from the earnings of the derivative used to hedge

5. Which of the following was changed with the recent issuance of ASU 2017-12 according to Ira Kawaller?
   a) accounting for a commodity hedge can now be based on an external reference price without delivery and other adjustments
   b) hedges no longer need to be documented to qualify for hedge accounting
   c) there are no longer cases where an explicit objective test to measure hedge effectiveness is necessary
   d) an entity must continue with subsequent quantitative testing of a hedge's effectiveness even if the initial quantitative test was passed
6. According to Ira Kawaller, what most often causes an entity to fail to demonstrate a derivative was used in an appropriate manner?
   a) significant volatility in the market price of the underlying commodity
   b) insufficient guidance from FASB on appropriate disclosures
   c) lack of board oversight on senior management over the use of derivatives
   d) deficiency in the design of effectiveness testing

7. Which of the following is correct for option contract buyers?
   a) gains and losses are both constrained
   b) gains are constrained while losses are unconstrained
   c) gains and losses are both unconstrained
   d) gains are unconstrained while losses are constrained

8. Which of the following is the most popular forward-type derivative?
   a) natural gas swap
   b) foreign currency exchange option
   c) interest rate swap
   d) natural hedge

9. Which of the following was eliminated by FASB under ASU 2017-12?
   a) separate recognition of periodic hedge ineffectiveness for cash flow and net investment hedges
   b) benchmark interest rate definition for hedges of fixed-rate financial instruments
   c) ability for an entity to voluntarily de-designate a hedging relationship
   d) the "highly effective" threshold for qualifying hedging relationships

10. Which of the following is correct about hedge effectiveness assessments under ASU 2017-12?
    a) all entities can perform either qualitative or quantitative assessments of initial hedge effectiveness
    b) an entity may perform the initial prospective assessment after hedge designation by using information available at hedge inception
    c) all entities must use the same assessment methodology in subsequent periods for all its hedges
    d) if an entity is required, or elects, to perform a quantitative assessment, it must continue to make quantitative assessments subsequently
Self-Study Option

Instructions for Segment

When taking a CPA Report segment on a self-study basis, an individual earns CPE credit by doing the following:

1. Viewing the video (approximately 30–35 minutes). The transcript of this video starts on page 4–16 of this guide.

2. Completing the Required Reading (approximately 25–30 minutes). The Required Reading for this segment starts below.

3. Completing the online steps (approximately 35–45 minutes). Please see pages iii to v at the beginning of this guide for instructions on completing these steps.

Required Reading (Self-Study)

TEN TENETS OF DERIVATIVES

By Dr. Ira G. Kawaller, Founder, Derivatives Litigation Services
For additional info, go to: www.derivativeslitigation.com

For corporate managers who are astute enough to realize that derivative instruments can be used to manage risks relating to interest rates, foreign exchange, and commodity prices, deciding what to do or how to do it is often a huge hurdle. Lack of knowledge is a tremendous barrier. The fact is, derivatives need not be intimidating. The simplest instruments and the simplest strategies are often the most effective. This article, then, is designed to present derivatives in a way to make them understandable and accessible.

The Ten Tenets

1. Derivatives are contractual arrangements that, when used as hedges, can be expected to generate gains concurrently with losses being realized in your underlying business. When you enter into a derivatives hedge, you still borrow using the same funding mechanism that was in place before the imposition of the hedge, or you exchange foreign currencies when you need to, or you buy or sell commodities as your business requires. In any such case, however, if you “pay too much” (or “receive too little”) the derivative should generate a gain that compensates – at least to some degree. On the other hand, if interest rates, exchange rates, or prices associated with your exposure end up moving to your benefit, you can expect your derivative to generate a loss.

2. What’s done is done. The use of derivatives for hedging purposes should always be forward looking. You’ll never be able to recoup prior losses. You should only be seeking to address the effects of price changes (interest rate changes or foreign exchange rate changes) that are yet to come. Given the forward looking nature of the hedging process, don’t think that hedges necessarily have to be maintained for the entire duration of an existing risk. It’s conceivable that you could decide to discontinue hedging, even though the risk might still be present. Most likely, the decision to terminate a hedge might be reasonable if the risk of an adverse price move seems less probable – either because
the influences that originally motivated the hedge no longer seem to be present, or because the price adjustment adverse price adjustment is deemed to be complete, such that further adverse changes are no longer expected. Of course, terminating the hedge early means you’re no longer protected if, despite your judgment to the contrary, further adverse price moves come about.

3. **Ultimately, derivatives fall into either of two categories – those having the potential of unconstrained gains or losses, or those where there is some limit or constraint on either the gains or the losses.** Those with some familiarity to derivatives will recognize that this division could alternatively be stated as “forward-type” derivatives versus “option-type” derivatives. Forward-type derivatives (inclusive of futures contracts and swap contracts) gain if the market moves in one direction, and lose in the other direction; and the magnitude of the gain or loss will be commensurate with extent of the market move of the underlying (or interest rate or exchange rate). Option-type derivatives have unconstrained results in one direction, but constrained results in the other.

For option buyers, gains are unconstrained while losses are constrained. For option sellers, it’s the reverse. Caps and floors are nothing more than a set of option contracts, bundled together. Caps pay off when prices move above a threshold value known as the cap’s “strike price” or “exercise price,” where the payoff reflects the difference between the market price and the strike – but only if the market price is higher than the strike. Similarly, floors pay off when the market price moves below floor’s strike price, where the payoff reflects the difference between the two – but only if the market price is below the strike.

In most cases, hedgers might think of using either forward-type hedges or buying caps or floors – irrespective of the risk being hedged. The former serves as a price-fixing (or un-fixing) mechanism, while the later works more like insurance that compensates you on only if the risk you are hedging is realized. In one particular situation, however, the option-type hedge is preferred -- when the hedged item has some probability of not occurring. For example, suppose you were bidding on an international project where your profit was contingent on (a) getting the business and (b) operating with a foreign exchange rate of exchange no worse than some threshold value. Under these conditions you’d probably favor a hedge with limited risk (e.g., a purchased option), as opposed to a derivative with unbounded loss exposure (e.g., a forward contract). If the company failed to secure the business and, at the same time, you’d be stuck with that loss as a cost of just “trying” for the business. With the purchased option, you’d know how the worst case loss outcome. With a forward contract, on the other hand, this loss would be unconstrained.

4. **No derivative is free.** One way or another, you have to pay for a derivative. For the forward-type derivative, this cost comes in the form of an opportunity cost. That is, for forward-type derivatives, depending on which way the associated market moves, the derivative could end up losing money – maybe a lot of money. Thus, at the onset of the derivative’s position, although there is no up-front cash requirement, the ultimate cost is uncertain. On the other hand, option-type derivatives do require an initial payment from the buyer to the seller at the inception of the trade. This cost of the option is known, up front; and it represents the largest loss that the option buyer could possibly realize.

5. **Forward-type derivatives are used to lock in prices that would otherwise be uncertain – or to unlock fixed prices when applied in the other direction.** The most popular forward-type derivative is an interest rate swap, which is used to synthetically convert fixed rate loans to variable rate loans, or vice versa. The same concept applies for any swap, however. For example, a natural gas purchaser who buys gas in the spot market and suffers with rising gas prices (or benefits from falling gas prices) can lock in his/her prices in advance by entering into a gas swap, analogously to the way the corporate treasurer locks in the interest expense using interest rate swaps in conjunction with
variable rate loans. Critically, the swap is a commitment, and you’re stuck with the outcome irrespective if the swap is offsetting the impact of adverse price changes on your underlying exposure, or beneficial price changes.

6. The most basic option hedge involves buying an option to protect against market moves in one direction. It may be most intuitive to refer to these options as caps and floors — whether in connection with a single pricing exposure or multiple exposures over time. In any case, a cap would be purchased to cover the exposure to the risk of rising prices or interest rates; while a floor would cover the exposure to the risk of falling prices or interest rates. The risk in question would determine which of the two —i.e., the cap or the floor -- would be the appropriate option to buy. For example, the gas purchaser exposed to the risk of higher gas prices would buy a cap; but the gas seller exposed to the risk of lower prices would buy a floor.

7. Derivative pricing will generally reflect consensus expectations as to where prices are headed in the future. Don’t for a minute think that you can lock in today’s spot prices (or interest rates or exchange rates) for future transactions. For forward-type derivatives, the price that the derivative will permit you to lock in will reflect these expectations; and the price of option-type hedges, too, will reflect these consensus views. This consideration is one that makes hedging particularly difficult. Just when risks seem most probable, derivatives will tend to be most costly.

8. Hedging need not be perceived to be an “all-or-nothing” proposition. All too often, when companies first consider using a derivative to hedge an exposure, they evaluate how the hedge would be expected to perform under a range of possible outcomes. This range of outcomes might be prepared by the prospective counterpart or a derivatives broker. Just because they show you the possible outcomes for a fully hedged position doesn’t mean that you should necessarily cover the entire risk. A perfectly reasonable course would be to cover only a portion of the exposure, appreciating, of course, that you won’t be fully protected; but at the same time, you’ll realize a lower cost of hedging — whether the cost is an opportunity cost or a direct payment of option premium.

9. The prices of options depend on both the consensus forecast relating to underlying prices (interest rate or exchange rates) and consensus expectations relating to market volatility. Higher volatility translates to a higher probability that you, the option buyer will receive (more) compensation from the seller, and hence the cost of that option (insurance) will be greater. Conversely, lower volatility translates to a lower probability and a lower cost. The trick in hedging with options is to buy the options before the threat of an adverse move is recognized by everyone else! The concept of one-sided protection is clearly appealing, but a critical question is whether the cost of this protection is appropriate or excessive.

10. Corporate hedgers — particularly at publicly traded companies — need to be aware of the accounting ramifications of hedging with derivatives. The objective of hedging is to generate compensation for an adverse income statement effect (i.e. higher expenses or lower revenues) or a deterioration of a balance sheet item (i.e., lower asset or net investment value, or higher liability value). In either case, the hedging mindset would typically hope to recognize gains or losses on derivatives in the same accounting period as the losses or gains of the associated “hedged item” are recognized. This desired accounting treatment, however, isn’t automatic. “Special hedge accounting” treatment is typically required; but qualifying for this treatment is not trivial. All hedging relationships for which hedge accounting is desired must be so-documented at or before the initiation of the hedge, and prospective and retrospective effectiveness tests must be satisfied as a prerequisite for applying this treatment. And, critically, incomplete or inaccurate documentation could pose the possibility of having to restate earnings.
Conclusion

Perhaps the most important thing to realize is that any users of derivatives can’t expect careful study and analysis to lead to choosing a derivative that will necessarily add to profitability. It may or it may not—but that should be the objective. Instead, the objective should be to end up realizing some predetermined, acceptable result that precludes the possibility of realizing an unacceptable outcome. The fact is, derivatives do what their designed to do. And if you choose a derivative contract with a full understand what it is capable of delivering, the outcome should never be a surprise, or entirely unwelcome.

FASB ISSUES STANDARD BRINGING TARGETED IMPROVEMENTS TO HEDGE ACCOUNTING

By Mark Bolton, Denis Rolfs, Casey Fersch, and Jon Howard, Deloitte & Touche LLP
Excerpted with permission of Deloitte US
For complete report, go to: https://www2.deloitte.com/us/en.html

On August 28, 2017, the FASB issued ASU 2017-12, which amends the hedge accounting recognition and presentation requirements in ASC 815. The Board’s objectives in issuing the

ASU are to (1) improve the transparency and understandability of information conveyed to financial statement users about an entity’s risk management activities by better aligning the entity’s financial reporting for hedging relationships with those risk management activities and (2) reduce the complexity of and simplify the application of hedge accounting by preparers.

FASB ISSUES STANDARD BRINGING TARGETED IMPROVEMENTS TO HEDGE ACCOUNTING

Hedging Concepts Retained by the ASU

ASU 2017-12 significantly alters the hedge accounting model by making it easier for an entity to achieve hedge accounting and have that accounting better reflect its risk management activities. Although the changes are substantial, constituents should note the following key aspects of hedge accounting under preadoption guidance that the Board retained:

- The “highly effective” threshold for qualifying hedging relationships.
- The ability for an entity to:
  - Voluntarily de-designate a hedging relationship.
  - Designate certain component risks of the hedged item as the hedged risk.
  - Apply the critical-terms-match method or the shortcut method.
- The benchmark interest rate definition and concept for hedges of fixed-rate financial instruments (i.e., fair value hedges of financial instruments).

- The required timing for the preparation of all hedge documentation for public companies and private companies that are financial institutions, except for the documentation related to the initial prospective quantitative hedge effectiveness assessment.

- A number of disclosure requirements.

**Key Changes to the Hedge Accounting Model**

The ASU makes a number of improvements to the hedge accounting model, including the four outlined below.

1. **Elimination of the Concept of Separately Recognizing Periodic Hedge Ineffectiveness**

ASU 2017-12 eliminates the concept of separately recognizing periodic hedge ineffectiveness for cash flow and net investment hedges (however, under the mechanics of fair value hedging, economic ineffectiveness will still be reflected in current earnings for those hedges). The Board believes that requiring an entity to record the impact of both the effective and ineffective components of a hedging relationship in the same financial reporting period and in the same income statement line item will make that entity’s risk management activities and their effect on the financial statements more transparent to financial statement users.

Under this rationale, even a portion of the change in a hedging instrument’s fair value that is excluded from a hedging relationship’s effectiveness assessment is considered part of the hedging relationship and should be recognized in the same income statement line item as the earnings effect of the hedged item (other than amounts excluded from the assessment of effectiveness of net investment hedges). However, in a departure from the proposed ASU, the Board determined that presentation should not be prescribed for “missed forecasts” in cash flow hedges. Thus, an entity that ultimately determines that it is probable that a hedged forecasted transaction will not occur will not be required to record the amounts reclassified out of accumulated other comprehensive income (AOCI) for that hedging relationship into earnings in the same income statement line item that would have been affected by the forecasted transaction.

Connecting the Dots: In paragraphs BC145 and BC146 of the ASU, the Board acknowledges that, unlike the preadoption hedge accounting model, the new model under ASU 2017-12 will defer the timing of recognition of any economic ineffectiveness arising from cash flow or net investment overhedges (and amounts recognized as net investment underhedges under the preadoption hedge accounting model will no longer be recognized). However, the Board believes that the new model will benefit constituents by (1) reducing the costs of administering a hedging program and (2) allowing users to more clearly identify how an entity’s hedging program has affected its financial statements, thereby resulting in more decision-useful information.

2. **Quantitative versus Qualitative Assessments of Hedge Effectiveness**

ASU 2017-12 requires an entity to perform an initial prospective quantitative hedge effectiveness assessment (by using either a dollar-offset test or a statistical method such as regression) unless the hedging relationship qualifies for application of one of the expedients that permits an assumption of perfect hedge effectiveness (e.g., the shortcut method or critical-terms-match method).

An entity may perform the initial prospective quantitative hedge effectiveness assessment after hedge designation by using information available at hedge inception; however, the entity must complete that assessment by the earlier of:
• “The first quarterly hedge effectiveness assessment date.”

• “The date that financial statements that include the hedged transaction are available to be issued.”

• “The date that any [required hedging criterion] no longer is met.”

• “The date of expiration, sale, termination, or exercise of the hedging instrument.”

• “The date of de-designation of the hedging relationship.”

• “For a cash flow hedge of a forecasted transaction . . . the date that the forecasted transaction occurs.”

If (1) an entity’s initial prospective quantitative hedge effectiveness assessment of a hedging relationship demonstrates there is a highly effective offset and (2) the entity can, at hedge inception, “reasonably support an expectation of high effectiveness on a qualitative basis in subsequent periods,” the entity may elect to perform subsequent retrospective and prospective effectiveness assessments qualitatively. To do so, in the hedge documentation it prepares at hedge inception, the entity must (1) specify how it will perform the qualitative assessments and (2) document the alternative quantitative assessment method that it would use if it later concludes, on the basis of a change in the hedging relationship’s facts and circumstances, that subsequent quantitative assessments will be necessary. The entity may make this election on a hedge-by-hedge basis.

Connecting the Dots: ASU 2017-12 notes that an entity’s determination of whether it can reasonably support qualitatively an expectation of high effectiveness will require the use of judgment and that the entity should consider (1) the results of the initial prospective quantitative hedge effectiveness assessment, (2) the extent to which the critical terms of the hedging instrument and the hedged item are aligned, and (3) the degree and consistency of correlation between changes in the underlyings of the hedging instrument and the hedged item.

ASU 2017-12 also states that “[a]n entity must document that it will perform the same quantitative assessment method for both initial and subsequent prospective hedge effectiveness assessments.”

The new standard states that after an entity makes its initial election, it must “verify and document whenever financial statements or earnings are reported and at least every three months that the facts and circumstances related to the hedging relationship have not changed such that it can assert qualitatively that the hedging relationship was and continues to be highly effective.” Indicators that may (individually or in the aggregate) allow an entity to continue to assert qualitatively that a hedging relationship continues to be highly effective include:

• No events or circumstances have affected the factors that originally enabled the entity to assess that it could reasonably support, qualitatively, an expectation that the hedging relationship was and will continue to be highly effective. An entity’s analysis of this indicator should consider the possible impact of any caps or floors that may be embedded in the hedged item on the overall effectiveness of the hedging relationship as well as changes in the effects of those features since the inception of the hedging relationship.

• No adverse developments have occurred related to the counterparty’s risk of default. An entity that initially elects to perform subsequent qualitative effectiveness assessments but later determines that the hedging relationship’s facts and circumstances have changed to the extent that qualitative assessments are no longer sufficient will be required under the new standard to quantitatively assess effectiveness at the time of the change by using the method specified in the initial hedge documentation. After the entity is required or elects (e.g., when it wishes to validate that its qualitative assessments of hedge effectiveness remain appropriate) to perform quantitative hedge effectiveness assessments, it may subsequently return to
making qualitative assessments if it can support them on the basis of the same factors it had used in its original qualitative assessments.

**Effective Date and Transition**

Effective Date: For public business entities, the ASU was effective for fiscal years beginning after December 15, 2018, and interim periods therein.

For all other entities, the ASU is effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020.

In addition, entities are permitted to early adopt the new guidance in any interim or annual period after issuance of the ASU. If an entity early adopts the updated guidance in an interim period, any transition adjustments should be reflected as of the beginning of the fiscal year that includes that interim period.

Transition: Entities will adopt the ASU’s provisions by applying a modified retrospective approach to existing hedging relationships as of the adoption date. Under this approach, entities with cash flow or net investment hedges will make (1) a cumulative-effect adjustment to AOCI so that the adjusted amount represents the cumulative change in the hedging instruments’ fair value since hedge inception (less any amounts that should have been recognized in earnings under the new accounting model) and (2) a corresponding adjustment to opening retained earnings as of the most recent period presented on the date of adoption.

In each annual and interim reporting period in the fiscal year of adoption, entities will also be required to provide certain disclosures required by ASC 250 about (1) the nature and reason for the change in accounting principle and (2) the cumulative effect of the change on the opening balance of affected components of equity or net assets as of the date of adoption.

In all interim periods and fiscal years ending after the date of adoption, entities should prospectively (1) present the entire change in the fair value of a hedging instrument in the same income statement line item(s) as the earnings effect of the hedged item when that hedged item affects earnings (other than amounts excluded from the assessment of net investment hedge effectiveness, for which the ASU does not prescribe presentation) and (2) provide the amended disclosures required by the new guidance.
4. Managing Your Risk: Tenets of Derivatives

SURRAN: There's no doubt that much is written about risk, including directives that are aimed at accountants and corporate financial executives, on how enterprises can manage their risks more effectively. And in that conversation, economists and quantitative risk specialists often advocate the use of derivatives as a way to measure and to mitigate the organization's risks. After all, derivatives can reduce the uncertainty for those enterprises, or those individuals, for whom uncertainty is undesirable. The historic example – ever since Aristotle in 350 B.C. – is the farmer, whose crops and whose profits depend on the cooperation of the weather.

While derivatives can't change the weather, they can change the financial implications of a drought. And since the market prices for key inputs in the production process – like commodities and interest rates – do fluctuate daily, future costs and profits are, by definition, uncertain. As a result, you won't be surprised that businesses can – and do – use derivatives to reduce their exposure to unexpected tremors in the markets for key goods and key costs. For example, Hershey's utilizes derivatives to protect their business from volatility in cocoa prices.

In the same way, the major airlines enter into derivative contracts to ensure that rising jet fuel prices won't ground their profits.

FOSTER: Ever since we began this program, viewers have complained that hedge accounting is one of the more complicated areas of financial reporting. But first, we want to focus on how and why our viewers and their enterprises use derivative instruments as a way to manage their risks.

With us, once again, is Dr. Ira Kawaller, the founder of Derivatives Litigation Services, who has provided us with guidance ever since the derivative accounting rules were first issued.

He reminds us, why managing risk is more precise – and more complex – than "just hiring smart people."

KAWALLER: There's a certain amount of risk management that, to my mind, is a bit amorphous. The solution to the risk management problem seems to be, "Be careful. Hire smart people." But derivatives are a more special case.

Derivatives are really concrete tools that let you address very explicit risk problems, specifically price risk or interest rate risk or foreign currency risk. All these things are prices.

In each case, there are derivative instruments that really allow you to affect a solution that is one that can be well-anticipated. Whereas in the other categories of risk management, again, no matter how careful you are, stuff happens. Derivatives is the one area in risk management where there's stuff that you can do about the stuff that happens, and you can preclude the problems from really plaguing you.

FOSTER: Beyond the weather, enterprises are often exposed to volatility and to risk in a variety of areas. As a result, businesses as well as individual investors often use derivatives to decrease their exposure to risk in several common areas: interest rates; foreign currency; and the purchase or sale of materials or commodities; as well as so-called credit or default risk.
Ira Kawaller evaluates whether there are specific types of transactions – or specific industries – that seem "ready-made" for derivatives and hedging.

KAWALLER: I think actually from my perspective, it's the reverse. Who is not ready-made for hedging? We're talking about something that's fundamental to any company – whether it's interest rate exposure, foreign currency exposure, price risk associated with their raw materials or final goods. This is essentially at the core of their existential rationale. So, to not have a facility with derivatives is something that always surprises me.

FOSTER: Most businesses, as well as their accountants and financial executives, have a profit motive. The good news is that derivatives can be used to apply gains to a losing position. But the bad news is that derivatives can also generate losses when things are going well.

KAWALLER: This is a funny area, where you have to really understand the appropriate mindset for using derivatives. You don't use derivatives because you think the derivatives are going to make you money necessarily.

You use the derivatives because, in a risk management orientation, you've identified an exposure where the nature of that exposure means that maybe you'll be better off, maybe you'll be worse off.

The notion of hedging in that context involves identifying a derivative that is closely related to the price behavior that is of concern where you can achieve somewhat of a balance, where when there's a loss on your normal exposure, you structure a hedge that compensates you and offsets that loss, with an appreciation that if the exposure serves to work in your favor, if you've hedged it with a derivative, then there'll be an offset in that case, too.

The critical point to understand is that your objective in using a derivative for risk management is to establish limits on the performance, or boundary conditions on the performance, as opposed to simply expecting to generate a gain from using the derivative position.

FOSTER: Financial statements, by definition, are looking at past results in the rearview mirror. As a result, it is in the nature of accountants to ask the logical question: is it possible to use derivatives for hedging purposes for what's already taken place?

KAWALLER: If only. The bottom line is: no, it's over.

If you experienced a loss from before, you experienced a loss from before. Your orientation when using derivatives for risk management purposes should always be forward-looking.

One of the problems that every manager faces in looking ahead at potential price movements that are going to affect their bottom line.

When we see a price perturbation, the real question is, "Is this indicative of a new trend in this direction, or is this something that's possibly noise that's going to be reversed in the future?"

Unfortunately, there's no way to know for sure one way or the other. Sometimes it works where this is the beginning of a trend, and sometimes it works where a reversal should be more anticipated.

In the case that you've sited with, "Gee, we had a big loss," you're still confronted with the question, "Yeah, there's nothing I can do about this big loss. But I am in a position to reevaluate, given this new information,
this change of circumstances, what's going to happen from here." We're confronted with the question that every manager really needs to address looking forward.

"Did this move that occurred now that fostered a disadvantageous price change, is this indicative of something that's more likely to persist and continue in the future, or is the bad news over and potentially we could see some reversion to our benefit?"

The bad news is instructive in terms of informing a view as to the probabilities for future price changes. That's the orientation that we have to address when we're thinking about using derivatives.

FOSTER: Investing has grown more complicated in recent decades, with the creation of numerous types of instruments that are designed to provide different ways of managing risk.

Ira Kawaller provides a basic distinction between the two main types of derivative instruments: "forward-type" derivatives versus "option-type" derivatives.

KAWALLER: Let's think about a company that's buying energy, obviously subject to the risk of energy prices rising and the potential benefit of energy prices falling. If they identify that risk as something that they potentially want to hedge, there are two basic alternatives that they can consider in setting their hedging objectives. They can think of locking in a price. By the way, I should mention, all of these strategies can apply to either all or none or any place in between. But for whatever portion of the exposure you want to address, you can think of on one hand locking in the price for that exposure, or you can think of just protecting myself from the adverse price movement.

When you lock in a price, you're using a forward-type derivative. You are locking in the forward market price for that contract. To be clear, you can't lock in whatever people are paying today.

You can only lock in what the consensus market view is that people expect to be paying in the future. If the prices of your energy are 100 today, but the mass market psychology is that, "Gee, these prices are going up," nobody would be willing to lock you in at today's price. They'd only lock you in at a price that reflects the consensus views as to where the price will likely be during the time frame that you're hedging.

After all, these contracts are negotiated on a basis where they're fair, where there's no a priori expectation that one party is better off at the very beginning, at the onset. So that's the forward-type hedge.

Now let's understand that I would likely be delighted to lock in a purchase price if, in fact, prices go up and had I not done it, I would've been paying a higher price. "Oh, that's wonderful."

But I have to appreciate that if I do choose to enter into a derivative to lock in the price and those market views don't turn out to work out, and in fact energy prices go lower, I'm stuck with the fact that I engaged in a contract that committed me to this fixed price that turns out to be higher than where the market went. This is an opportunity cost.

When using a forward-type derivative to lock in a price, there's no direct payments at the onset, but you have to have this willingness to bear this opportunity cost in the event that the risk that you feared doesn't turn out to occur.
The alternative to the forward-type price for the entity that says, "Gee, I am afraid of those energy prices going up, but I don't want to give away the benefit of energy prices going down. I don't want to lock in a price. I just want protection against the adverse price movement." This is something that is totally analogous to the purchase of insurance. Nobody's going to protect you from an adverse consequence without being paid for it.

So you are going to have to pay for this insurance to cover you in the contingent case that those energy prices rise. If it turns out that the energy prices don't go up, they go down, you will have paid a premium for that protection, but you get to enjoy the lower cost of energy.

Every hedge manager has the choice to make. "What's my objective, and what's the balance between how much I potentially could pay up front for a desired amount of protection versus not paying anything up front but bearing the risk that I'll generate an opportunity cost if the market happens to move in other than in the risk direction that was a source of concern?"

FOSTER: The famous saying is that "there's no such thing as a free lunch. In other words, when goods and services are provided, someone must pay for them. According to Ira Kawaller, derivative instruments do, and don't, follow the general rule.

KAWALLER: In a way, we're talking about a semantic issue here. I agree generally that there's no such thing as a free lunch.

In the context of derivatives, you do have the capability of entering into a derivative without having a direct cash payment between the parties. That would be the forward-type of derivative that we talked about, where you're potentially able to lock in a price. But again, we should understand that it's not free. There is an opportunity cost to it.

Again, with the option contracts, those that serve insurance policies that protect against one side of a market move, they're clearly not free. But they're fair. When I say they're fair, if you think about these things as bets, they're entered into on a basis where there's no seeming advantage of one side over the other. In well-defined and liquid markets for derivatives they are actively traded, so there are parties on both sides. If there were an advantage on one, then that would foster a price adjustment to wipe it out.

FOSTER: From the way Ira Kavaller describes it, it sounds as if derivatives can work in two ways. For businesses or people who've already locked in a price on a commodity or an interest rate on a loan, they can get the benefits of the "spot market" or variable rates. But by the same token, those on the other side of the fence can use derivative instruments to lock in their prices or rates ahead of time.

KAWALLER: Just to make it concrete: think about the wheat market. We have farmers who are selling it and we have bakers who are buying it. On both sides, there could be an interest in managing the price risk. For the farmers, they'd want to either lock in a price or assure that prices don't fall. For the bakers, they would either want to lock in a price or assure that the prices don't rise.

That kind of really goes to the idea that, gee, one side or the other shouldn't have a price advantage. It's a symmetric kind of opportunity.

FOSTER: There may be some people who just don't like the volatility of the market – meaning, of course, any market. After all, in most cases, the greater the
volatility, the riskier the security. But doesn't it seem as if most hedging activity is designed to protect against market moves in one direction or the other – either a cap or a floor?

KAWALLER: When we're talking about volatility, it's most relevant or more relevant in the context of the option-type derivatives, the ones that serve to work like the insurance, as opposed to the price fixing or forward-type derivatives. When we think about the insurance model, where somebody's looking to buy protection from the risk of prices going higher or prices going lower, either way, the question is, "Okay. If I want to buy that protection, what does it cost? What's the premium for that protection?"

That will very much depend on market consensus views as to, "How volatile is it? How likely is it that the price can be dramatically higher or dramatically lower?" Certainly if there's a market consensus that, "Oh, gee, things are very, very volatile, especially volatile," that means the risk of an especially large price move is greater and you should expect that nobody will provide you with that insurance policy as cheaply as they did last year when the views of the market were more sanguine.

FOSTER: Some people pride themselves on getting a good deal. So, they'd like to assure themselves that they can lock in today's spot prices or interest rates for their future transactions. Yet, options are priced based on "consensus expectations." But Ira Kawaller reminds us, that – in some instances – that's no different than determining an up-to-the-second value for the Dow Jones Industrial Average.

KAWALLER: Actually, it is. That is so cool about it. All these derivatives are really here because of the foundation of the futures market. The futures market and options on futures are transparently operated, where the prices are disseminated literally minute to minute. People can very, very explicitly identify a market consensus forecasted price by referring to the futures market. Analogously, by looking at the options market, traded at the futures exchange, the option on futures market, you can infer the expected volatility that people are anticipating. It is actually a very objective measure that people are considering when we think about pricing these kinds of derivatives.

Clearly, for a protracted time through the end of 2018, the Fed was pretty direct about anticipating rate increases in the key fed funds rate. That position was well-reflected in terms of the futures market. The futures market simply mimicked or mirrored this explicit policy statement that the Fed was making. Then market conditions changed, and the Fed took a more patient view and decided that they're going to not necessarily be ratcheting interest rates up further at this time. As a consequence, we saw that the futures market reflected that change here.

Very explicitly, you can look at the futures market to see where those forecasts are. In an analogous way, when we think about the insurance protection, the one-sided or option-type protection, the prices of the various options that relate to those derivatives adjust up and down as the sensibility about the market volatility by the market participants tends to change.

FOSTER: In examining their risk, some enterprises are told that they have a "natural hedge." Or that they have a so-called "fully hedged position." But is that the same as saying that their entire risk is "covered" by derivatives?

KAWALLER: As an example, somebody who both imports and exports in the same country with comparable volumes ...
That's called a "natural" hedge. They're both buying and selling that foreign currency, and their needs are comparable.

Their exposure would only relate to a net difference in those two things. If they wanted to be fully hedged, they'd address that net difference with derivatives.

The spectrum runs from "leave the exposure where it is, have no mitigating effect" to "completely 100% cover this exposure." The vast majority of people who identify an exposure will take some kind of a middle ground. They'll think about hedging some portion of this. In fact, I think prudent risk managers will tend to revisit the question, both with a regular frequency on a periodic basis, and also in response to substantive changes in market conditions. I think it's reasonable and prudent to, as time goes by, think about adjusting your hedge coverage.

As an example, suppose I start and I know that I have 100 units of exposure for a given time frame. I might start by covering or hedging 50% of the risk. I'm clearly hedging, but I'm only hedging part of the exposure.

Then as time goes by, as I mentioned before, I still think I need to be having a forward-looking view. I took that 50% coverage based on some sensibility of the probabilities of an adverse move versus the probabilities of a beneficial move.

Now with time going by and more information, that perspective might change, and I might feel that, "Gee, in the current market environment, the potential for risk has a higher probability than it had before." I might decide it's appropriate to increase my hedge coverage at that point.

Or alternatively, if I felt that the probabilities were that the risk of an adverse price move has diminished somewhat, I might decide that it's appropriate to reduce my hedge coverage.

I think this is a very tricky area for people, because ... What I'm suggesting here, that it's appropriate to increase the coverage, decrease the coverage, adjust it up, adjust it down ... It's critical for me to say that this needs to be done in a circumspect way. If somebody's making those adjustments in the first half-hour of trading in the course of a day, that doesn't sound like a prudent risk management orientation. But if we're dealing with a considered adjustment that reflects some time going on and genuine new information as opposed to noise, then I think it's more than appropriate to do it that way.

FOSTER: Before he returns to hedge accounting questions, Ira Kawaller reminds enterprises of the importance of maintaining oversight and audit coverage over any derivative activities.

KAWALLER: The kinds of risks that lend themselves to hedging with derivatives are interest rate risk, currency risk, commodity price risk, which are all very fundamental types of exposures that potentially could threaten the existence of an organization. The idea of not treating these risks in a serious and thoughtful and disciplined manner seems to me to be an abrogation of fiduciary responsibility.

One of the things that's tricky here is that it is technical information. The authority to act and use these markets is often concentrated in a very narrow set of individuals. It's an area where oversight is appropriate, and responsible board members deserve or need to have some understanding
to be able to make sure that these issues are being controlled and managed appropriately.

So I think there are two remedies that companies should be thinking about. One is that, to assure that the knowledge is not concentrated in an individual. And the oversight of that individual is not compromised, I think it's appropriate to have periodic audits, where some independent, external resource who has these facilities can evaluate what's going on and provide a report to senior management or the board. That's kind of at a minimum.

SURRAN: On the one hand, accountants and financial executives have long complained that hedge accounting, or accounting for derivative instruments, is one of the more complicated areas of financial reporting. But on the other hand, the standard setters have until recently been challenged to provide the information that investors and other financial statement users need to make informed decisions. Fortunately, FASB has finally addressed the concerns of preparers who found the hedge accounting rules burdensome as well as users who had difficulty understanding some of the presentations of hedge accounting information.

With the recent issuance of ASU 2017-12, the standard setter has found a way to:

One, simplify hedge accounting treatment;

Two, reflect the economic results of hedging in the financial statements; and

Three, better align accounting rules with a company's risk management activities.

FOSTER: Of course, in the ideal world, when it comes to the accounting of hedging with derivatives, enterprises would be able to generate compensation from their hedging activity for any adverse income statement effect that they experience. But as accountants, they want Ira Kawaller to explain: to what extent can you recognize the gains or losses from the derivatives in the same accounting period as the gains or losses from the hedged item are recognized?

KAWALLER: That question is central to whether or not hedge accounting is applied. Hedging accounting is something that explicitly serves that objective of assuring that whenever you recognize the gains or losses on a thing that you're hedging, the hedged item, that there will be a concurrent earnings recognition from the derivative that's used to hedge. That's an accounting solution that is available as long as certain prerequisite conditions are satisfied. It's an elective accounting treatment. So for companies that don't care about that coincident earnings recognition, they don't have to take the steps necessary to qualify for that situation.

But more likely than not, certainly for public companies where there's scrutiny of their income statements on a wide basis, having the concurrent earnings recognition of the hedged item and the hedging derivative would be something that has a high priority.

FOSTER: Yet, in some instances, the gains and losses from the hedging activity don't take place in the same period as the underlying asset. As in many areas of financial reporting, this means – according to Ira Kawaller – that you must provide disclosures for the users of your financial statements.
KAWALLER: You do have to make all kinds of disclosures with derivatives. You have to explain why you're using them. Whether you're qualifying for this hedge accounting or not, there are explicit disclosure requirements. You conceivably could tell somebody, "Gee, I haven't qualified for hedge accounting, but while I lost on my exposure, I will be making it up next quarter or over some time frame in the future, or vice versa." You could explain that. But whether or not analysts will fully appreciate that and recognize that as being something they could take to the bank is a question.

I think, without any question, the preferred treatment for anybody who recognizes that they're going to put their financial statements in front of somebody else, the preferred treatment would be to try to qualify for this hedge accounting.

The good news is that with a significant amendment that came at the end of 2018, or I should say that applies for the beginning of 2018, satisfying the prerequisite conditions for hedge accounting has clearly been liberalized. It's a lot easier than it had been. My own sensibility is that the level of scrutiny that the auditing firms have given to this issue has diminished somewhat.

FOSTER: One of the disclosures that financial statement preparers especially disliked under the old rules involved so-called effectiveness assessments for hedging transactions. Ira Kawaller reports to what extent, under the new FASB rules, they are still required.

KAWALLER: To qualify for hedge accounting, one of the requirements is that these hedges still do need to be documented, and the question of effectiveness is something that needs to be addressed.

But in the liberalization vein that I mentioned before, it's easier these days for people to more or less identify the fact that the derivatives are well tailored to the exposure, and kind of on a more subjective basis, assert that they will be sufficiently effective.

There are certainly some cases where an explicit objective test is still necessary. But the categories of cases where a qualitative orientation, or one that simply makes the assertion that the hedge is going to work well, will suffice. Even when quantitative testing is required, it's further been liberalized where if you do the test once and you pass it with flying colors, then you may not have to do another quantitative test again. There's a little ambiguity, but as I said before, I think the level of scrutiny has diminished. So to the extent that you've satisfied this test at the onset, a great many entities are going to be just fine after that.

FOSTER: Some viewers will recall that commodity hedges were particularly difficult to report under the old rules. So, what happens now, if you hedge the price of natural gas using the so-called Henry Hub futures quote?

KAWALLER: The Financial Accounting Standard Board, which makes up these accounting rules, has done a good job of listening to their constituents, to the reporting public. The reporting public asserted that these kinds of prerequisite conditions were onerous, and often they tended to disallow hedge accounting in cases where economically, it just didn't seem right, didn't sit well. I think that FASB was sensitive to these things, and they made important liberalizing adjustments.

One, perhaps, major adjustment that they made had to do with commodity hedges. In the original standard, originally FAS 133, ASC 815, the
qualifying conditions for commodity hedges asserted that you had to be able to validate that the derivative offset the entire price exposure of the commodity in question. In many cases, we buy or sell raw commodities on the basis of some industry reference price with adders or adjustments to them.

So in the earlier version of the hedge accounting rules, they said, "You have to look at the entire price, inclusive of these adders, and discern whether or not this derivative that you're thinking of using, which referenced that industry standard price without those adjustments. How well did this derivative offset the full price of your exposure?" In many cases, that basis amount, those adders or adjustments, were more volatile than the underlying kind of benchmark good. When that occurred, hedge accounting was problematic.

In the new amended rules, FASB said, "Gee, if you have a contractual arrangement to buy or sell a commodity based on some external reference price with adjustments, then you can hedge just that external reference price."

This was a very significant accommodation to the way a lot of people do business in the commodities world. As an example with natural gas, a lot of natural gas pricing is keyed off of the prices from Henry Hub, and derivatives are keyed off the price of Henry Hub.

So this is a natural case where the derivative now can hedge the Henry Hub component of the gas and not worry about the delivery and locational differences that otherwise would be charged.

FOSTER: In unveiling the new rules for derivative transactions, FASB stated that one of their objectives would be to better align the accounting rules with companies' risk management activities. In that context, Ira Kawaller gives a favorable grade to the standard setters.

KAWALLER: My own sensibility about the idea of qualifying for hedge accounting, which had been a much more problematic issue than it currently is ... My own sensibility was that if, in fact, you're using a derivative in an appropriate manner, one that does make economic sense, then by God, you surely ought to be able to demonstrate that this is going to work well, that your economic objectives will be satisfied. More often than not, I've found that, to the extent that people failed in satisfying the prerequisite, it was because the design of their effectiveness test was somehow deficient.

FASB didn't give an explicit prescription of exactly how these tests had to be performed. That was left to the discretion of the reporting entity to design and affect these tests or proceed with these tests in a manner that they deemed to be appropriate. If you're failing, then one of two things is wrong. Either the rationale for using these things is not supported by the way the markets work, or else you performed a lousy test.

I think what they've done now through their more qualitative orientation is they've taken a lot of the bumps out of the road and made it easier for people to not get tripped up and not have to apply tests that didn't turn out right.

FOSTER: As always, Ira Kawaller – the founder of Derivatives Litigation Services – covered a lot of ground for us this month. He concludes by providing his response to the question that he is asked most often by accountants and
corporate executives: "Do you think we should get into using derivatives and hedging?"

KAWALLER: I like to turn the question around. I want to say, "Gee, you're not using derivatives? Why wouldn't you? Why wouldn't you at least have the capability to engage in these instruments?" Because boy, the idea that no circumstances or no situations will arise where these things would make a lot of sense ... That just is hollow. Sooner or later, there will be situations where these risks are going to be confronting you in a manner where you're going to want to do something about it, and you can't do it unless you have the capability and an understanding of how these instruments work.
# Evaluation Form

Please rate the segments on the April 2019 issue
5 = Excellent, 4 = Very Good, 3 = Good, 2 = Fair, 1 = Poor

## I. Segment

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<td>1. After April 15th: Making Time for Extended Returns</td>
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Please comment on each segment you used. (Attach additional pages if needed.)

**Segment 1:** ____________________________________________

**Segment 2:** ____________________________________________

**Segment 3:** ____________________________________________

**Segment 4:** ____________________________________________

**Suggested Topics to be covered in future volumes (please comment):**

__________________________________________________________________________

__________________________________________________________________________
II. Discussion Leader

Please rate the discussion leaders
5 = Excellent, 4 = Very Good, 3 = Good, 2 = Fair, 1 = Poor

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III. Summary

Were learning objectives met?  ❑ Yes  ❑ No

Were prerequisite requirements appropriate?:  ❑ Yes  ❑ No

Were course materials valuable?  ❑ Yes  ❑ No

Was course content up-to-date?  ❑ Yes  ❑ No

Were completion times appropriate?  ❑ Yes  ❑ No

Were the facilities satisfactory?  ❑ Yes  ❑ No

Name (please print):

Title:

Firm:

City/State:

Date:

Send to:

RFR
Kaplan Professional Education
332 Front Street, Suite 501
La Crosse, WI 54061
Note: At the request of several subscribers, this Index reflects the most recent 11 months of CPAR programming rather than the current calendar year.

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Group Attendance and CPE Record

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Segment Title ____________________________________________________________________________

Location of Seminar ____________________________________________________________________________

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I hereby certify that the above individuals viewed this portion of CPA Report, participated in the group discussion, and earned the recommended hours of CPE credit.

Discussion leader _______________________________ Date completed ______________

All CPE hours listed are recommended. They are developed in a manner consistent with AICPA guidelines. Since CPE requirements vary by state and/or professional organization, we suggest you contact the appropriate organization for information about their requirements.