Post Busy Season Reflections on the Tax Cuts and Jobs Act of 2017

Making Compliance Great Again

Primary Objectives of the TCJA

• Simplification
• Revenue Neutral
• Economic Growth
• Tax relief for middle-income families
• Repatriation of overseas income
Simplification

Revenue Neutral

YOU GET A TAX CUT. YOU GET A TAX CUT

EVERYONE GETS A TAX CUT!
Economic Growth

Percent change in level relative to pre-TCJA baseline projections

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>1.2%</td>
<td>0.8%</td>
<td>1.0%</td>
<td>0.2%</td>
</tr>
<tr>
<td>Consumption</td>
<td>*</td>
<td>3.1%</td>
<td>1.6%</td>
<td>0.2%</td>
</tr>
<tr>
<td>Investment</td>
<td>7.3%</td>
<td>-6.9%</td>
<td>0.2%</td>
<td>0.3%</td>
</tr>
<tr>
<td>Capital stock</td>
<td>0.6%</td>
<td>0.8%</td>
<td>0.7%</td>
<td>0.3%</td>
</tr>
<tr>
<td>After tax wage rate</td>
<td>3.6%</td>
<td>2.6%</td>
<td>3.1%</td>
<td>0.1%</td>
</tr>
<tr>
<td>Labor supply</td>
<td>1.5%</td>
<td>0.8%</td>
<td>1.1%</td>
<td>*</td>
</tr>
</tbody>
</table>

*Less than 0.05% in magnitude

Tax Relief for Middle Income Taxpayers

Figure 1

Shares of Federal Tax Cuts Going to Each Income Group, 2001 Through 2018

Excludes tax break "autofillers" for businesses file bonus depreciation
Source: ITEP analysis
Repatriation

Companies Are Bringing Back More Cash Since Enactment of the TCJA
Dividends and Withdrawals, Dollars in Billions

$350
$300
$250
$200
$150
$100
$50
0


Source: U.S. Bureau of Economic Analysis, “Table 4.2 U.S. International Transactions in Primary Income as Direct Investments”

TCJA Overview - Individual

• High Points
  • Standard deduction increase
  • Adjustments to itemized deductions
  • Expansion of brackets and reduction of rates
  • Kiddie Tax simplification
  • Child Tax Credit increase
  • “Postcard” return
Other Observations - Individuals

• 80% estimated tax penalty threshold
• Elimination in reduction of certain itemized deductions (Pease Limitation)
• Backdoor Roths are still alive
• 529 Plan expansions
• Sales people and unreimbursed employee expenses
• Opportunity Zones

Opportunity Zone Example – 5 year

• Facts
  • Taxpayer has $90,000 in LT capital gain at the end of 2018.
  • Within 6 months he invests $100,000 in an opportunity zone.
  • Assume 20% capital gain rate
  • Sells OZ property in 2024 for $400,000

• Tax on original deferral – $16,200
  • 90,000 x 90% x 20%
• Tax on OZ property gain - $60,000
  • (400,000-100,000) x 20%
Opportunity Zone Example – 7 year

• Facts
  • Taxpayer has $90,000 in LT capital gain at the end of 2018.
  • Within 6 months he invests $100,000 in an opportunity zone.
  • Assume 20% capital gain rate
  • Sells OZ property in 2026 for $600,000

  • Tax on original deferral – $15,300
  90,000 x 85% x 20%
  • Tax on OZ property gain - $80,000
  (500,000-100,000) x 20%

Opportunity Zone Example – 10 year

• Facts
  • Taxpayer has $90,000 in LT capital gain at the end of 2018.
  • Within 6 months he invests $100,000 in an opportunity zone.
  • Assume 20% capital gain rate
  • Sells OZ property in 2028 for $1,000,000

  • Tax on original deferral – $15,300 – Paid December 31, 2026
  90,000 x 85% x 20%
  • Tax on OZ property gain - $18,000
  (1,000,000-100,000) x 10% (non deferral amount) x 20%
TCJA Overview – Business

- High Points
  - Corporate rate cut to 21%
  - Repeal of Corporate AMT
  - Sec 199A – 20% deduction for flow through entities
  - 100% bonus depreciation
  - Leasehold improvements – Qualified Improvement Property
  - Methods of Accounting
  - Meals & Entertainment

Meals & Entertainment

<table>
<thead>
<tr>
<th>Examples of Meals &amp; Entertainment</th>
<th>2017/Prior</th>
<th>2018 Rules</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business Entertainment Trips or Events (sporting events, concerts, fishing trips, country club dues, movies, etc.)</td>
<td>50% deductible</td>
<td>Nondeductible</td>
</tr>
<tr>
<td>Tickets to Charitable Events</td>
<td>100% deductible</td>
<td>Nondeductible</td>
</tr>
<tr>
<td>Business Meals (with associates, clients, customers or prospects)</td>
<td>50% deductible</td>
<td>50% Deductible</td>
</tr>
<tr>
<td>Employee Travel Meals</td>
<td>50% deductible</td>
<td>50% Deductible</td>
</tr>
<tr>
<td>Meals for Business Leagues (Chamber of Commerce, Boards of Trade, etc.)</td>
<td>50% deductible</td>
<td>50% Deductible</td>
</tr>
<tr>
<td>Meals for Meetings (with employees, stockholders, agents or directors)</td>
<td>50% deductible</td>
<td>50% Deductible</td>
</tr>
<tr>
<td>Meals Provided for Convenience of Employer</td>
<td>100% deductible</td>
<td>50% Deductible</td>
</tr>
<tr>
<td>Employee Events (holiday parties, summer outings, other social/recreational activities)</td>
<td>100% deductible</td>
<td>100% Deductible</td>
</tr>
<tr>
<td>Office Snacks &amp; Beverages</td>
<td>100% deductible</td>
<td>100% Deductible</td>
</tr>
</tbody>
</table>
Methods of Accounting

• Expansion of Cash Method of Accounting
• Exemption from UNICAP
• Taxpayers Not Required to Keep Inventories
• Exception for Completed-Contract Method
• Advanced Payments

Cash Method of Accounting

• TCJA provides that taxpayers, other than tax shelters, that satisfy the $25 million gross receipts test may use the cash method of accounting regardless of whether the purchase, production, or sale of merchandise is an income-producing factor
• Previous threshold under pre-TCJA law was $5 million
Taxpayers Not Required to Keep Inventories

• Under pre-TCJA law, businesses that are required to use an inventory method must generally use the accrual accounting method.
• For tax years beginning after Dec. 31, 2017, taxpayers that meet the $25 million gross receipts test are not required to account for inventories but rather may use an accounting method for inventories that either:
  • Treats inventories as non-incidental materials and supplies, or
  • Conforms to the taxpayer’s financial accounting treatment of inventories

Exemption from UNICAP

• The TCJA expands the exception for small taxpayers from the uniform capitalization rules by providing that any producer or reseller that meets the $25 million gross receipts test is exempted from the application of §263A.
• The provision retains the exemptions from the uniform capitalization rules that are not based on a taxpayer’s gross receipts.
Exception for Completed Contract Method

• The TCJA expanded the exception for small construction contracts from the requirement to use the percentage-of-completion method.
• Contracts within this exception are those contracts for the construction or improvement of real property.
  • < 2 years
  • < $25 Million

Advanced Payments

• Generally, the TCJA provides that revenue can only be deferred for tax purposes if it is deferred for financial statement purposes
• TCJA codifies Revenue Procedure 2004-34 which provides that advance payments can only be deferred to the year after the year of receipt or sooner, if so reported on applicable financial statements
• Not all financial statements are applicable financial statements
• This change does not apply to long-term contract accounting or installment sale reporting
Method Change Procedures (Rev. Proc. 2018-60)

- Change to cash method was a non-automatic change pre TCJA
- Rev. Proc. 2018-60 provides a streamlined method change procedure
- Small business taxpayers ($25M) can change without a Form 3115
- No audit protection on change without Form 3115
- Still need to calculate the 481(a) adjustment
  - Traditional adjustment periods apply

199A – Qualified Business Income Deduction

- General Overview and Eligibility
- Talking to your kids about SSTBs
- Real Estate and 199A
- Aggregation
199A Overview

• Up to 20% deduction for certain non C-Corp businesses.
• Potentially limited for taxpayers with taxable income over threshold (Single $210,700/MFJ $421,400)
  • Can’t be Specified Service Trade or Business (SSTB)
  • 50% of the taxpayer's share of the W-2 wages or
  • The sum of 25% of the W-2 wages plus 2.5% of the taxpayer’s share of the unadjusted basis immediately after acquisition (UBIA) of all qualified property.
• Deduction adjustments for Schedule C businesses

SSTBs

• Don’t be a...
  • Doctor
  • Lawyer
  • CPA
  • Actuary
  • Performer
  • Consultant
  • Athlete
  • Financial Advisor
  • Product Endorser
Other SSTB Issues

- SSTB Taint
- Services or property provided to SSTB
- Incidental to a SSTB
- Allocation of items among directly conducted businesses

Real Estate and 199A

- Elective Safe Harbor (Notice 2019-7)
  - Statement must be attached to return
  - Can still meet the requirement of Trade or Business under Sec 162 without the safe harbor election.
- Sec 469 and 199A
- Like Kind Exchanges and UBIA
- Self Rentals
199A Aggregation Rules

• Optional
• Cannot be SSTB
• Control Requirements (>50%)
• Other Requirements (2 out of 3)
  • Product and services are same or customarily offered together
  • Share significant centralized business elements
  • Operated in coordination with one of more business in the aggregated group
• Consistent
• Disclosure requirements

Aggregation Example

• Partnerships A,B,C are all restaurants with centralized overhead
• Partnerships are all owned 60% by Bill and 40% by John (not related)
• Bill chooses not to aggregate the partnerships for 199A
• John choose to aggregate based on Bill meeting the control definition.
Aggregation Example

• 2018 Operations

<table>
<thead>
<tr>
<th></th>
<th>QBI</th>
<th>QBI Allocation</th>
<th>Wage Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Bill</td>
<td>John</td>
</tr>
<tr>
<td>Partnership A</td>
<td>100,000</td>
<td>60,000</td>
<td>40,000</td>
</tr>
<tr>
<td>Partnership B</td>
<td>(250,000)</td>
<td>(150,000)</td>
<td>(100,000)</td>
</tr>
<tr>
<td>Partnership C</td>
<td>50,000</td>
<td>30,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Totals</td>
<td>(100,000)</td>
<td>(60,000)</td>
<td>(40,000)</td>
</tr>
</tbody>
</table>

Both Bill and John will have negative QBI for 2018 (Bill 60,000 and John 40,000). Let’s see what happens in 2019.

Aggregation Example

• 2019 Operations

<table>
<thead>
<tr>
<th></th>
<th>QBI</th>
<th>QBI Allocation</th>
<th>Wage Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Bill</td>
<td>John</td>
</tr>
<tr>
<td>Partnership A</td>
<td>300,000</td>
<td>180,000</td>
<td>120,000</td>
</tr>
<tr>
<td>Partnership B</td>
<td>(100,000)</td>
<td>(60,000)</td>
<td>(40,000)</td>
</tr>
<tr>
<td>Partnership C</td>
<td>100,000</td>
<td>60,000</td>
<td>40,000</td>
</tr>
<tr>
<td>Totals</td>
<td>300,000</td>
<td>180,000</td>
<td>120,000</td>
</tr>
</tbody>
</table>

• Bill has 180,000 of CY QBI and 60,000 of allocated wages
• John has 120,000 of CY QBI and 40,000 of allocated wages
Aggregation Example

• Bill 2019 (non aggregation)
  • Because there is a negative QBI from 2018 and a loss from Partnership B we must allocate the negative amounts to Partnership A & C.
  • A is 75% of the positive QBI and C is 25% of the positive QBI.
  • We will allocate 120,000 of negative QBI (60,000 from 2018 and 60,000 from Partnership B).
    • Partnership A will be allocated 90,000 (120,000 x 75%)
    • Partnership C will be allocated 30,000 (120,000 x 25%)

• Wages from 2018 do not carryover to 2019

Aggregation Example

Bill Summary

• Because he doesn’t aggregate is only receiving 15% QBI deduction instead of 20%

<table>
<thead>
<tr>
<th></th>
<th>QBI</th>
<th>Allocation</th>
<th>Allocated</th>
<th>Wages</th>
<th>Deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partnership A</td>
<td>180,000</td>
<td>(90,000)</td>
<td>90,000</td>
<td>54,000</td>
<td>18,000</td>
</tr>
<tr>
<td>Partnership B</td>
<td>(60,000)</td>
<td>60,000</td>
<td>-</td>
<td>6,000</td>
<td>-</td>
</tr>
<tr>
<td>Partnership C</td>
<td>60,000</td>
<td>(30,000)</td>
<td>30,000</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Prior Year QBI</td>
<td>(60,000)</td>
<td>60,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Totals</td>
<td>120,000</td>
<td>-</td>
<td>120,000</td>
<td>60,000</td>
<td>18,000</td>
</tr>
</tbody>
</table>
Aggregation Example

• John 2019 (aggregation)
  • Must bring forward the negative QBI from 2018.
  • Since John aggregates we look at all 3 business together including the 2018 carryover
• Wages from 2018 do not carryover to 2019

Aggregation Example

John Summary
• Because he aggregates John is receiving the full 20% QBI

<table>
<thead>
<tr>
<th></th>
<th>QBI</th>
<th>Allocation</th>
<th>Allocated</th>
<th>Wages</th>
<th>Deduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partnership A</td>
<td>120,000</td>
<td>120,000</td>
<td></td>
<td>36,000</td>
<td></td>
</tr>
<tr>
<td>Partnership B</td>
<td>(40,000)</td>
<td>(40,000)</td>
<td></td>
<td>4,000</td>
<td></td>
</tr>
<tr>
<td>Partnership C</td>
<td>40,000</td>
<td>40,000</td>
<td></td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Prior Year QBI</td>
<td>(40,000)</td>
<td>(40,000)</td>
<td></td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>80,000</td>
<td>-</td>
<td>80,000</td>
<td>40,000</td>
<td>16,000</td>
</tr>
</tbody>
</table>
Aggregation

- Isn’t always the best answer.
- Can be made at the individual level or at the Relevant Passthrough Entity (RPE) level.

<table>
<thead>
<tr>
<th></th>
<th>Business 1</th>
<th>Business 2</th>
<th>Aggregated</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 QBI</td>
<td>100,000</td>
<td>100,000</td>
<td>200,000</td>
</tr>
<tr>
<td>2 W-2 Wages</td>
<td>40,000</td>
<td>-</td>
<td>40,000</td>
</tr>
<tr>
<td>3 UBI</td>
<td>-</td>
<td>800,000</td>
<td>800,000</td>
</tr>
<tr>
<td>4 50% of W-2 Wages</td>
<td>20,000</td>
<td>-</td>
<td>20,000</td>
</tr>
<tr>
<td>5 25% of W-2 Wages + 2.5% of UBI</td>
<td>10,000</td>
<td>20,000</td>
<td>30,000</td>
</tr>
<tr>
<td>6 20% of QBI</td>
<td>20,000</td>
<td>20,000</td>
<td>40,000</td>
</tr>
<tr>
<td>7 Greater of 4 or 5</td>
<td>20,000</td>
<td>20,000</td>
<td>30,000</td>
</tr>
<tr>
<td>8 QBI Deduction</td>
<td>20,000</td>
<td>20,000</td>
<td>30,000</td>
</tr>
</tbody>
</table>

Syndicate Rules and 163(j)

- Sec 163(j) – Generally limits business interest deduction to 30% of adjusted taxable income
- Applies to:
  - Entities with over 25 million in average annual gross receipts
  - Tax Shelters
Syndicate Rules and 163(j)

• Tax Shelter
  • Very broad definition used under Sec 461(i)(3)
    • any enterprise (other than a C corporation) if at any time interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having the authority to regulate the offering of securities for sale,
    • any syndicate (within the meaning of section 1256(e)(3)(B)), and
    • any tax shelter (as defined in section 6662(d)(2)(C)(ii)).

Syndicate Rules and 163(j)

• What’s a Syndicate (Sec 1256(e)(3)(B)
  • Entity other than C-Corp
  • Allocation of 35% of the losses to limited partners or “limited entrepreneurs”
Entity Choice

C-Corps

**Advantages**
- No AMT
- Dividends paid at capital gains rates
- Availability of §1202 and §1244
- No Built-in gains/passive investment taxes

**Disadvantages**
- Double taxation
- NIIT
- General accrual basis accounting method
- Accumulated earnings tax

S-Corps

**Advantages**
- §1244 stock for ordinary losses
- No SE taxes on distributions
- No double taxation
- Flow-through of losses and NOLs

**Disadvantages**
- Limit on number of shareholders and class of stock
- No §1202 gain exclusion
- Fringe benefit taxation for greater than 2% owners
- Built-in gains/passive investment taxes

Conclusion

The TCJA = The CPA Jobs Act
Intelligent Automation Overview and Finance Application

USF Accounting Circle
May 2019

Cost reduction of 35% – 65% for onshore operations and 10 – 30% for offshore operations

Institute for Robotic Process Automation

Disrupt or be disrupted?
Headlines capturing attention of executives everywhere

30% – 40% of existing business process services are likely to be impacted by RPA

Gartner

RPA is estimated to lead to 30% – 35% reduction in entry level roles and increase mid level roles

Everest Group

Estimated that 85% of a typical firm’s 900+ processes can be automated. 110 to 140m FTEs could be replaced by 2025

McKinsey & Company

Cost reduction of 35% – 65% for onshore operations and 10 – 30% for offshore operations

Institute for Robotic Process Automation
RPA drives immediate cost savings, quality improvements and faster speed plus a time dividend

Optimizes delivery and outcomes:
- Zero-defect handling and improved exception management with audit trail
- Virtual workforce scales to peak loads without penalty with 24/7 operations
- 50% - 70% reduction in high-frequency repeated tasks
- 1/3 of the cost of offshore FTE; 1/10 of the costs of local US FTE

Protecs and leverages investments:
- Support strategic platform upgrades and regulatory change
- Digitally enable legacy systems for customer self-management
- Enhance usability and ease change in new system deployment
- Product and platform agnostic and work with existing IT architecture

Time dividend for knowledge workers:
- Quality improvements by shifting focus from readying data to exploiting it
- Captures benefits without costly BPR, creating bandwidth for value proposition reengineering (VPR) and growth
- More accurate and timely reporting and insight
- Accelerate innovation in product and customer engagement without reliance on IT development queue

Introduction to RPA
Software Robotics, or Robotic Process Automation (RPA) promises to transform the cost, efficiency and quality of executing many of the back office and customer-facing processes that businesses rely on people to perform
Robotic Process Automation (RPA)

Robotic Process Automation (RPA) is software that mimics human interaction with core systems, web, and desktop applications to execute processes; working through the same interface that humans use. “Robotics enables a virtual workforce.”

“You take the robot out of the human”

“Robotics takes the robot out of the human”

Characteristics and benefits of RPA:
1. RPA robots enable “fast IT” because they sit on top of existing systems leveraging data and controls in place.
2. The Robots work 24/7, with consistency and accuracy, but at a speed much faster than humans (1 robot = 4-5 human FTEs of work).
3. Benefits can include:
   - Cost reduction
   - Increased productivity for high value employees
   - Scalability
   - Improved accuracy
   - Enhanced revenue

Intelligent Automation (IA) – market update

Organizations are “learning” and capturing quick wins with RPA, creating a “new normal” of efficiency and effectiveness, but AI and Human/Machine collaboration will fundamentally reinvent industries, generating entirely new opportunities and business models.

The IA journey

- The automation market is estimated to be US$19b by 2020.
  - While less than 5% of companies are at scale with RPA today, ~40% say they are moving to scale in the next 12 to 18 months - Everest Research, 2018
  - “Companies that have already invested in RPA tools plan to increase the number of bots deployed by more than 90% in the next 12 months” - Horses for Sources, 2018
  - EY is recognizing the convergence of robotic process automation (RPA), analytics, machine learning (ML) and artificial intelligence (AI), but most companies are starting their journey with RPA.

Percentage of business processes impacted

<table>
<thead>
<tr>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Robotic process automation (RPA) traditional</td>
<td>Cognitive RPA</td>
<td>Intelligent chatbots</td>
<td>Artificial intelligence</td>
<td>Human &amp; Machine Collaboration</td>
</tr>
<tr>
<td>15%–20%</td>
<td>10%–15%</td>
<td>&lt;10%</td>
<td>15%–20%</td>
<td>5%–15%</td>
</tr>
</tbody>
</table>

Repetitive, rule based, high volume activities

60%–70%
Intelligent Automation (IA) as an enabler
A constellation of technologies, maturing at different speeds, that can work independently or collaboratively to help an organization enable business outcomes.

Robotic Process Automation (RPA)
Robotic Process Automation (RPA) is software that mimics rules based, human interaction with core systems, web and desktop applications to execute processes, working through the same interface that humans use.

Machine Learning (ML)
Machine Learning is the science of enabling computers to learn skills and facts from experience. Machine Learning algorithms build prediction models from labeled examples, by analyzing similarity in data, and through trial and error.

Document Intelligence (DI)
Artificial Intelligence solution that enables organizations to process form based documents by extracting relevant data elements into a structured format, with the use of various algorithms and Machine Learning techniques.

Natural Language Processing (NLP)
Component of artificial intelligence concerned with the interactions between computers and human (natural) languages. NLP software helps computers understand, interpret and manipulate human language.

Virtual Agents (VA)
A conversational, computer generated character that simulates a conversation to deliver voice or text based information to a user via a Web, kiosk or mobile interface.

Computer Vision (CV)
Computer vision allows computers to see, identify and process images.

Demonstration COX Enterprises

Cox Enterprises, Inc. is a privately held global conglomerate headquartered in Atlanta, Georgia with approximately 55,000 employees and $21 billion in total revenue. Its major operating subsidiaries are Cox Communications, Cox Automotive and Cox Media Group. The company's major national brands include AutoTrader, Kelley Blue Book, Cox Homelife, Gamut and more. Through Cox Automotive, the company's international operations stretch across Asia, Australia, Europe and Latin America.
IA lessons learned and guiding principles
Organizations that have achieved significant benefits have learned what it takes to be successful

**Guiding Principle #1 – Focus on purpose and business issues first**

Building a “program” that activates multiple functions and Business Units (BUs) around a common purpose and set of success metrics, is the best method to scale and achieve significant benefits.

**Guiding Principle #2 – Plan for process and organizational change**

To ensure automation efforts lead to real improvement, it is necessary to evaluate and manage organizational and process changes required to roles, responsibilities and reporting structures.

**Guiding Principle #3 – Consider IA solutions holistically**

IA is a spectrum of technologies that should work together. Assessing the impact of Robotic Process Automation (RPA) and various forms of AI together is most effective and efficient.

**Guiding Principle #4 – Use a balanced implementation approach**

We believe it is important to keep the 3 work streams below in sync with each other to ensure longer term success and avoid delays in reaching the Automation ROI.

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Guiding Principle #1 – Focus on solving business issues
IA as a component of Finance Transformation (FT)

IA is only one solution in the FT journey but can be a critical component to reduce cost and better align talented resources to decision support activities.

**Problem Statement:** How can Finance do "more with less" – reduce the amount of time Finance staff spend on transaction processing and manual, repetitive tasks so they can focus on higher value, decision support functions?

Cost savings and activity realignment are achieved by addressing:
- Finance process redesign
- System enhancements
- Organization design

Example Benchmarks:
- Finance FTEs per $1b of Revenue
- Finance Cost as a % of Revenue
- % time spent on decision support
- % Finance FTEs in CBS vs. Retained

Activating the business around purpose and value

Building a “program” that activates multiple functions and Business Units (BUs) around a common purpose and set of success metrics, is the best method to scale and achieve significant benefits.
Start by defining the “business outcomes” or purpose for automation and how success will be measured

**Improve Efficiency**
- When systems integrate human, robotic and cognitive automation, a new level of performance occurs and the basis for competition shifts.

**Optimize Performance**
- Intelligent models can learn from data and discover deeper insights to improve performance, scaling human-like judgment.

**Sustain Trust**
- Robotic, cognitive and autonomous systems can improve accuracy, identify and defend against network threats, see patterns of fraud and promote compliance.

**Enhance Experiences**
- Customer, employee and vendor experiences and interfaces are evolving to reflect technology that can now predict, sense, learn, understand, engage and navigate.

**Generate Revenue**
- AI can be applied to discover deeper insights from unstructured data to react quicker to customer trends and product issues.

**Potential Success Metrics**
- FTE reduction
- Freed up FTE capacity
- Cost avoidance
- Reduced contingent and contract labor
- Dollar savings

- Improved accuracy
- Better predictability
- Pricing support
- Reduced waste
- Fewer returns
- Loss downtime
- Increased sales

- Increased testing/audit coverage
- Less fraud incidents
- Contract compliance %
- Hard dollar savings

- Improved customer, employee & vendor satisfaction scores
- Customer retention
- Employee retention
- Recruiting hires to offers percentage
- Increased sales

- Cross-sell revenue $
- Upsell revenue $
- Increased $/order
- Increased %/order
- If new products
- Reduced stock outs
- Lower obsolescence

---

### Example use cases
Most organizations have hundreds of sub-processes that could be improved with automation

<table>
<thead>
<tr>
<th>Improve Efficiency</th>
<th>Optimize Performance</th>
<th>Sustain Trust</th>
<th>Enhance Experiences</th>
<th>Generate Revenue</th>
</tr>
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<tbody>
<tr>
<td><strong>Finance &amp; Accounting</strong></td>
<td>• Billing / Invoicing / cash applied</td>
<td>• Predictive financial forecasting</td>
<td>• GRIR Clearing</td>
<td>• Customer set-up and credit approvals</td>
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<tr>
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<td>• Payments processing</td>
<td>• Cash forecasting</td>
<td>• Contract compliance</td>
<td>• Automated customer segmentation analysis</td>
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<tr>
<td></td>
<td>• Account &amp; bank reconciliations</td>
<td>• Product price optimization</td>
<td>• New Contract generation</td>
<td>• Price elasticity analysis</td>
</tr>
<tr>
<td></td>
<td>• Journal entry support</td>
<td>• Standard costing updates</td>
<td>• Fraud detection analytics</td>
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<td></td>
<td>• FP&amp;A data support</td>
<td>• Stock out forecasting</td>
<td>• Expense auditing</td>
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</tbody>
</table>

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Automation “use cases” for Finance
Illustrative examples – not meant to be exhaustive

Financial Revising & Analysis (FRA)
- RPA - Training data to support automated generation of budgetary input
- RPA - Automating the preparation of annual reviews based on historical data
- AI – Predictive financial forecasting using Machine Learning

Accounts Receivable processing (OCR)
- RPA - Credit approvals & customer master file maintenance
- RPA - Order processing
- RPA - Credit memo processing against AR & sending transaction via email
- AI - RPA - AI to predict payment timing and AR to send email timing confirm

Accounts payable processing (P2P)
- RPA - Vendor set up and maintenance
- RPA – Goods Received vs. Invoice Received
- AI/RPA – OCR Data entry and payments
- RPA - Automating the workflow processes and approval
- AI – Vendor Scorecard

Regulatory & Management reporting
- RPA - Data capture and cleaning to support automated generation of regulatory inputs
- RPA - Pre-populating complex annual reporting
- RPA - Automating the preparation of management reviews based on historical data from multiple finance systems and reports

Expense Reimbursement
- AI – OCR review of 100% of receipts
- RPA - Automating policy compliance review
- RPA - Calculation of purchase discounts
- RPA - Compliance and segmentation reporting
- RPA - IP Card or expense program maintenance

Intercompany reconciliation
- RPA - Automated processing and reconciliation of intercompany balances
- RPA - Data entry and processing for reconciliation
- RPA - Creating exception file and email report for Exception review and approval

Account and Bank reconciliations
- RPA - Automating the download of subaccount balances and bank statements
- RPA - Uploading detailed transaction data from various sub systems
- RPA - Reconciling balances and transactions to core finance sub systems
- RPA - Creating balancing journal entries to handle discrepancies

Guiding Principle #2 – Plan for process and org. changes
The operating model will need to change for the future workforce
Humans and robots teaming together, creating a powerful virtual workforce

Robots do the “what”, freeing up humans to focus on the “why”

“Our goal is to take the robot out of the human and put the human into the robot”
- EY RPA client

Potential impact of the Robotics workforce

- Easily and quickly scale up and down potentially eliminating the need for contingent labor during peak periods
- Consider insourcing tasks previously outsourced
- Reduce cost without moving more jobs offshore
- Top grade onshore workforce to provide:
  - Advanced analytics & insights
  - Process improvements
  - Decision support

Planning for organizational impacts of IA
To ensure automation efforts lead to real improvement, it is necessary to evaluate organization changes to processes, roles, responsibilities and reporting structures

Modeling and digital organization
- Identification and modeling of opportunities to address organization efficiencies using digital levers such as Intelligent Automation
- Applying digital algorithms to identify and present visual representations of organization changes, driving action oriented discussions with leaders
- Establishing baseline operational costs and savings targets

Organization and role design
- Integrated coordination and governance to enable enterprise-wide org design process
- Utilization of org data fed directly from multiple HR data sources in modeling environment: analytics to support quality org design
- Ability to include contingent data for total workforce planning
- Projected cost of org estimates during planning phases

Talent planning
- Accelerated talent due diligence and minimized talent loss
- Transparent and fair selection process
- Proactive management of talent
- Holistic approach that aligns to org announcements, timing and cascading of communications

Transition planning
- Manage the planning and scheduling of actual employee movements
- Effective on and off-boarding to protect employee experience and corporate reputation
- Ability to generate data outputs and analyses for legal and compliance support
- Customizable data extracts to feed downstream systems ability to serve as “interim HRIS” during transition period

Financial tracking, P&L impact
- Forecast and confirm the P&L impact of the organization change
- Provide In Period and Run Rate savings forecast and actual views
- Data extracts and reports to support budget planning, including current data, actual savings and planned savings
- Consolidated and source system (Finance source system) views of P&L and Budget data
Understanding current state processes and effort

Tools like Celonis and Pega help companies understand where time is spent and the associated root cause (impacts of exceptions to standard process, bottlenecks, etc.) leading to immediate process improvement as well as providing fact driven data to aid Intelligent Automation efforts.

RPA has significant time and money saving potential, but there are equally significant challenges to maximize RPA’s potential. In fact, according to Ernst and Young, half of RPA implementations fail due to lack of adoption, and the cost of training robots can surpass $10x the cost of the robots themselves.

Guiding Principle #3 – Consider IA solutions holistically
Consider all technologies up front to prioritize benefit realization

Automation as a “spectrum”

Strucutred Data Interaction (Desktop Automation)
A broad set of custom tools that extract, aggregate and manipulate data from various sources, typically in an uncontrolled environment

Robotics process automation (RPA):
A software solution that runs unattended, working like a virtual employee with legacy applications performing repetitive tasks reliably at the UI level

Cognitive or Artificial Intelligence (AI):
A broad set of complementary technologies that can be brought together to automate a process

Guiding Principle #4 – Use a balanced implementation approach
EY Automation approach
How do most organizations get started? We believe it is important to keep the 3 work streams below in sync to avoid delays in reaching the Automation ROI

1. IA Strategy Development
   Steer the program
   - Define the purpose & performance metrics
   - Activate appropriate champions across functions and Businesses
   - Create the enterprise-wide or functional-opportunity, ideation & prioritization (Leveraging EY's Top-Down and Bottoms-Up Approach)
   - Develop high-level business case
   - Define the Roadmap (Sprints)
   - Define the demand and staffing needs
to deliver
   - Plan for the organizational impact (communications, change management & organizational design)

2. Establish operating model
   Lay the foundation
   Stand-up the critical elements of the Automation Operating Model
   - Strategy & Planning – program governance, team structure and roles. Select software and plan program reporting
   - Allignment & Governance – Align program to transformation initiatives, develop communication plan, policies & standards
   - Process Lifecycle (Build-Deploy) – Start with EY’s Methodology and Playbook, then modify as appropriate
   - Ongoing Management – Define first years support model

3. Automation delivery & IT enablement
   Accelerate execution
   - Select vendors
   - Infrastructure design and set up
   - Develop initial pilot applications
   - Supplement internal team with EY experienced developer resources and Infuse build best practices
   - Define risk and control matrix
   - Deploy ongoing management teams
   - Develop additional more complex applications

Work stream 1: IA Strategy (Opportunity Assessment)
EY’s 9 step approach

1. Define Purpose and Goals
2. Development of principles and scope
3. Top down analysis and summary
4. Ideation (crowd source + leading practices)
5. Detailed process review
6. Prioritization
7. Roadmap
8. Business case summary
9. Management report

Leadership meeting(s) to define purpose, program goals & communication
Data collection & analysis by major sub-process to filter top opportunities
Review of EY leading practice use cases and ideas from business units
Review of “Level 2” before and after process to calculate anticipated savings for down selected processes
A final Management Readout Report summarizing findings

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Work stream #2: IA Operating Model Playbook

The framework below and our 350+ page EY Playbook is modified to your needs and provides a consistent methodology/approach to delivering speed-to-value and mitigating risk.

Fire integrated work streams to ensure value realization

1. Strategy & Planning
   - 1.1 Program Purpose
     - Benefit articulation
     - Executive sponsorship
     - Funding availability
   - 1.2 High Level Business Case
     - Top down, data driven analysis
     - Program benefits
     - Alignment to other strategic initiatives
     - Funding model
   - 1.3 Business & IT Readiness
     - Business case consolidation
     - System strategy
     - Data integrity
     - Vendor management
   - 1.4 Program Structure
     - Model options (Centrally vs Decentralized)
     - Roles & responsibilities
     - Skill assessment
   - 1.5 Value Measurement
     - Performance metrics
     - Baseline establishment
     - Management reporting
     - Downstream tracking

2. Alignment & Governance
   - 2.1 Stakeholder & Change Management
     - Leadership alignment
     - sponsorship
     - Readiness Assessment
     - Communication plan
   - 2.2 Vendor Management
     - Outsourcing
     - Training / Skills Development
     - Scheduling
     - Monitoring/Review
   - 2.3 Policies & Standards
     - Compliance
     - Contracts
     - SarbAoC
     - ISVs
     - Asset Management
     - IA Risk & Controls
     - Development Protocols
     - Program Prioritization
     - Monitoring/Review
     - Scheduling
     - Training / Skills & Development
     - Communication Plan
     - Change Network
     - Leadership Alignment

3. Process Lifecycle
   - 3.1 Opportunity Identification
     - Review IA leading practices & use cases
     - Business & IT alignment
     - Solution / Thought Leadership
   - 3.2 Detailed Opportunity Assessment & Prioritization
     - IA solution determination
     - Data collection (benefit / risk)
     - High level current & future state
     - Business & IC alignment
   - 3.3 Implementation Design
     - Detailed process mapping & scope capture
     - Cost Benefit Analysis (CBA)
     - Sprint prioritization

4. Technology Development
   - 4.1 IA Technology Selection
     - Plan / Sprint / Review
     - Transition to ongoing management model
   - 4.2 Agile Approach
     - Executive sponsorship
     - Benefit definition
     - Value case and stakeholder management
     - Planning meeting
     - Definition of scope & features

5. Ongoing Management
   - 5.1 Daily
     - Bolts scheduling
     - Real-time monitoring of IA technology lifecycle
     - Real-time monitoring of IT infrastructure
     - Capacity management
     - Automation tracking
     - Incident Management and SLA adherence
   - 5.2 Periodic
     - Oversight and governance
     - Management of Change Central Panel
     - Provision & configuration of new servers
     - Communications with application owners
     - Communications with IT & security
     - Enterprise integrity
     - Infrastructure improvements

Work stream #3: Automation Application Build approach

We use a “Modified Agile” implementation approach tailored to IA. The approach does lock down requirements due to the rapid implementation timeframe but uses Agile concepts for design, build and testing phases.
The Problem Statement
IA is harder than it looks, and much harder than it's being sold

**RPA has been sold** on the proposition that enterprise process automation can be **simple, quick and cheap**, even before organizations reach maturity. This will undoubtedly bring **more reports of “failure”** (e.g. more expensive than planned, not achieving intended ROI, harder to maintain than expected, etc.)

**Common challenges to overcome (from “experimenting” to “value realization”):**

- Lack of Cross Functional Business Champion
- No Specific Purpose or Goals
- Limited View of Program Potential
- Insufficient Budget and Internal Resources
- Rapid Deployment Lifecycle & Delivery Issues
- IT Infrastructure Set-Up and Access
- Understanding Process & Org Changes Required
- IT Involvement Required for Long-Term Support
Common options to begin the IA journey

“Sequential Approach” - Prove success and model to organization

<table>
<thead>
<tr>
<th>Depth of Delivery</th>
<th>Breadth of the Business</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Finance</td>
</tr>
<tr>
<td>Strategy &amp; Operating Model</td>
<td>Phase 1</td>
</tr>
<tr>
<td>Data and Opportunity Discovery plus benchmarking (8-10 areas)</td>
<td>Deep dive process analysis and Business Case (top 25)</td>
</tr>
</tbody>
</table>

Seven mantras on our journey

1. Get sponsorship, define strategy and set desired outcomes & targets early in the process
2. Perform the proper analysis upfront to target and prioritize the right processes
3. Start small and build upon automated processes with scale in mind
4. Involve IT early understanding processes to be automated and applications involved
5. Improve processes or eliminate before applying automation
6. Establish the right governance model and monitor progress
7. Establish & execute a strong change management plan and benefits realization tracking
Top RPA solution tools Q2 2018
We have focused on “the big three” and believe each can be effective depending on client needs / preferences

EY’s key points of view on the current state of the RPA market:
► The landscape is rapidly developing, but three firms are currently top of class
► An innovative, high growth technology: we expect to see the marketplace continue to change as it reaches maturity in the coming years
► The software bots will grow increasingly smarter and more capable as artificial intelligence and machine learning become more mainstream
► Tools fall into two main categories:
  ► Attended automation, where bots prompt humans to take actions in a workflow, such as next best action in a call center
  ► Unattended automation, where bots operate independently in ‘lights out’ style

What’s next for RPA and IA
► More advanced functional and sector specific use cases focused on front office and more complex back office functions
► Move to scale – while less than 5% of companies are currently at scale with RPA, multiple studies show a significant movement to scale with RPA in the next 12-24 months and this is consistent with our conversations with clients and prospects
► More combined RPA and AI solutions recognizing the increased benefit of deploying the entire spectrum of automation
► Creation of “reusable assets” in a “bot library” that provide “art of the possible” ideation and accelerators to deployment across business units (EY has already developed RPA and AI combined solutions such as “Miley” for payments processing and “Lighthouse”, a predictive forecasting tool)

“There is an immense potential in the automation various business functions: Finance and accounting 61%-80%, customer care, IT helpdesk and procurement can be automated up to a range of 41%-69%”
-IDC, 2018

“Companies that have already invested in RPA tools plan to increase the number of bots deployed by more than 90% in the next 12 months”
-Horses for Sources, 2018
EY’s internal experience and success
1.7m hours of annual benefit within 2 years of embarking on the RPA journey

► Implemented 649 bots in EY shared services and tax in 4 years;
► Applied RPA to 358 processes – some very complex; 100,000 tax filings
► Estimated value – 1,700,000 annual hours of freed-up capacity in Tax (and growing); 6 to 9 month payback
► RPA has been catalyst for process improvements and standardization – 200+ internal tax process improvements
► Sustained business impact – driving value for our people, clients and the firm

### Functional area examples
- Business Tax Compliance
- HR recruiting and payroll
- HR onboarding
- Reporting
- Sales and use tax
- Asset management
- Property tax
- Expat tax
- Global tax reporting
- FATCA
- WOTC
- 5500s

### Globally connected team
Centralized, global enterprise COE with solution architects and configurators and SMEs

### RPA technology
Blue Prism and Automation Anywhere

### Efficiency
Automating processes replacing 4+ number of FTEs

### Sustainability and growth
Light central governance with post-production operational agility and proactive change management
Expanding digital workforce capacity

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For more information, please contact:
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About EY

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ey.com
Changing Dynamics of State Taxation

SPEAKERS
Cathie Stanton, CPA
Partner
National Leader, State & Local Tax Services
May 17, 2019

Today’s Topics

- All Things Wayfair!
- State Income/Franchise Tax
- SALT Trends and Other Matters
All sales of tangible personal property are subject to sales tax unless an exemption is available.

Most common exemptions: resale, manufacturing, exempt customer (charitable, government, etc.).

Sales of services are generally exempt unless the state enacts a statute to tax (although a handful of states tax most services).

Software, SaaS, technology viewed differently among the states.

“True object” of transaction determines whether a sale of property or services is made.
Constitutional Nexus Requirements

In General

Both the Commerce Clause and Due Process Clause require nexus in order for a state to have jurisdiction to impose a tax.

Due Process Clause Nexus Requirements

In the field of state taxation, due process requires a minimal connection between a state and a corporation for the state to impose taxes. Looks to “fairness”.

The due process “minimum contacts” nexus test may be satisfied without requiring physical presence in a particular state. Generally achieved when business is purposefully pursuing a market within the state.

Commerce Clause

Complete Auto Transit v. Brady (1977) 430 US 274

- In order to comply with Commerce Clause requirements, a state tax must:
  - be applied to an activity with a substantial nexus with the taxing state;
  - be fairly apportioned;
  - not discriminate against interstate commerce; and
  - be fairly related to services provided by the taxing state.
Pre-Wayfair Nexus Expansion

- Any type of physical presence furthering a market for products/services in the state
- Affiliate nexus
- Click through nexus
- In-state software ("cookie" nexus)
- Use tax notice and reporting
- Marketplace provider collection (i.e. Amazon)

Supreme Court Ruling: South Dakota v. Wayfair

- Ended the decades old battle between business & states
- Economic Nexus Standard, physical presence no longer necessary
- Decision handed down on 6/21/18
- States quickly began passing economic nexus laws
A company is deemed to have **nexus** with the taxing state even if it only has sales in the state.

### 39 states and DC have passed economic nexus laws

- $100,000 in sales or 200 transactions
- No retroactivity
- Simplification

### Even for small sellers, 200 transactions can be a small number

#### Economic Nexus Requirements by State

<table>
<thead>
<tr>
<th>State</th>
<th>Sales Threshold</th>
<th>Transaction Threshold</th>
<th>Effective Date</th>
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<tr>
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<td>10/1/2018</td>
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<tr>
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<td>04/25/2019</td>
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<td>$100,000 200</td>
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**Sales tax collected by a marketplace facilitator**

**Disclaimer:** This is for informational purposes only and is current as of 4/30/19. The information is based on the best available information and is not guaranteed or endorsed by Cherry Bekaert LLP.
How States Track Down Remote Sellers

- Nexus Questionnaires
- Data Analytics from other tax types
- Audit of Customers
- Other States Audit Questionnaires
- Subpoenas
- Stopping trucks at the borders
- Rewards for information
- Competitors

Tax Obligations Multiply in Post-Wayfair World

- Approximately 10,000 sales tax jurisdictions in United States
- Economic nexus increases sales tax obligations for many businesses.
- States more aggressively seeking remote sellers
Increased Compliance Burden

Should this be a DIY function?

- Collecting tax in more states = more tax returns to be filed
- More resources
- Risks of mismanagement
- Increased number of audits
- Less staff time to spend on value-added activities

What Should I Do Now?

- Review Nexus Obligations
- Review product Taxability
- Streamline sales tax collection and compliance functions
- Keep your eyes on sales tax.
- Ask for help.
Marketplace Facilitator Legislation

Growing trend by states to impose tax collection responsibilities on the marketplace on behalf of 3rd party sellers.

- 13 states active
- 11 states effective w/i year
- Additional states pending

Use Tax Reporting Requirements

Require non-collecting sellers to:

- Notify customers about their potential use tax liability
- Provide customers with an annual purchase summary
- Provide the state with a customer information report
- Sellers may collect sales tax rather than comply with the requirements
- The penalty for non-compliance is extremely high (OK, PA & WA)
Watch for These Trends

- State expansion of tax base
  - Digital Goods & Streaming Services
  - More taxes on services
- More taxes on “sin” goods
  - Vaping products
- Tax rate changes
  - Especially local changes

State Income/Franchise Tax
Federal Law Protection

Federal Law – Public Law 86-272

States may not impose net income tax if the only business activity in the state is solicitation activity for the sale of tangible personal property.
P.L. 86-272: Scope of Protection

There are limitations on the scope of protection afforded taxpayers by the federal statute.

**Applies to**
- Net Income Tax
- Sales of Tangible personal property
- Interstate Commerce
- Non-domiciliary business

**Does NOT apply to**
- Any other tax (gross receipts, margin, net worth, etc.)
- Sales of services or intangibles
- Foreign Commerce
- Residents or entities organized/ incorporated in the state

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Wisconsin Department of Revenue v. William Wrigley, Jr., Co. (1992) 505 US 214

- Supreme Court held that “solicitation” includes not only actual requests for purchases; but also other activities that are entirely ancillary to the request.
- Activities must:
  - Serve no independent business function apart from their connection to the solicitation of orders.
  - It is not enough to facilitate sales—an activity must facilitate the requesting of sales.
Economic/Factor Presence Nexus

- Not dependent on physical presence
- Quill Corp V. North Dakota, 504 US 298 (1992)
  - Sales tax case
  - Doesn’t apply to other taxes
- Majority of states agree that income/gross receipts tax nexus can be triggered by receiving a certain amount of revenue from a state; **pre-Wayfair**.
MTC first enacted its Factor Presence Nexus Standard for Business Activity Taxes in 2002. The model law provides that substantial nexus is established if any of the following thresholds is exceeded during the tax period:

- $50,000 or 25% of total property
- $50,000 or 25% of total payroll
- $500,000 or 25% of total sales
Most state income based taxes are built around some level of conformity with the Federal Internal Revenue Code (IRC) to calculate State Taxable Income.

- **Rolling Conformity**
  - Always staying in general conformance with current version of the IRC.

- **Static Conformity**
  - Generally conforming to the IRC as of a specific date.

- **Selective Conformity**
  - Conforming to select provisions of the IRC

Source: Thompson Reuters Checkpoint
TCJA – SALT Implications

States will continue to react to tax reform by coupling or decoupling with specific tax reform provisions including:

- Bonus depreciation
- Interest deduction limitation
- Section 179 expensing threshold
- Section 199A pass-through deduction
- International tax provisions

State Workarounds – SALT Cap
State Responses to $10k SALT Cap

- Law suit! New York, New Jersey, Connecticut and Maryland sued Trump Administration
  - Violates Due Process and 10th Amendment (State sovereignty)
  - Justice Department is seeking to have the case tossed.

State Responses to $10k SALT Cap

- Shift personal income tax to an employer payroll tax
  - New York’s Employer Compensation Expense Tax (ECET)

- Creation of government sponsored “charities”
  - Make contributions to a “charity” and you get a tax credit against your state or local tax liabilities (New York, New Jersey, Connecticut)
  - Enacted in 2018 - CT, NJ, NY, and OR
  - States considering – CA, IL, and RI
  - Significant risk due to IRS proposed regulations
  - Over 100 existing programs at risk, across 33 states
State Responses to $10k SALT Cap

- Create a pass-through entity tax
  - Enacted in 2018 – CT and WI
  - Pass-through Entity-Level Tax Election: Oklahoma Governor Kevin Stitt on April 29 signed a measure, H.B. 2665, to establish an elective pass-through entity tax in the State.
  - Proposed in Louisiana; election to pay corporate income tax
  - Being considered - AR, IA, MI, MN, NJ, NY and RI
SALT filing deadline changes to take into account federal filing date changes (see AICPA webpage)

Kaestner Trust – Can a state tax a trust when only connection is the residency of beneficiaries? Supreme Ct. Hearing April 16th, decision expected by June.

Partnership audits – New federal partnership audit and assessment procedures under Bipartisan Budget Act. Significant state impact, as burden for tax may be imposed on the partnership instead of partners. A number of states have enacted, or considering legislation to address.

New Oregon gross receipts (commercial activity) tax likely to be signed. Tax is $250 plus 0.49% of taxable commercial activity over $1 million. Expect to see additional gross receipts taxes.

Expansion of sales tax base to capture digital goods and services

States continue trend of decreasing corporate income tax rates (CT, NM, IN, DC)

Legalization and taxation of sports betting (*Murphy v. National Collegiate Athletic Association*)

The emergence of legalized recreational marijuana and its taxation
Questions??
SOC Reporting: Keeping Pace with a Changing Business Landscape

Dan Collins, MBA, CPA
President & CEO
360 Advanced

Outline

• Introduction
• Drivers of Change – the Changing Business and Technology Landscape
• Trends Related to Information Assurance, Trust, and Regulatory Compliance
• Current State of SOC Reporting
• What’s Next?
• Resources and Reference Materials
Introduction

Guiding principles for this presentation

• Most CPAs in public and private practice are exposed to or effected by SOC reporting at or beyond the periphery of the actual examination process; thus, this presentation will explore the broader implications of SOC reporting, with less focus on those that are directly involved at the engagement level.

• This presentation is intended to be an insightful business discussion related to SOC reporting, with focus on the high-level state and relevance to the current business environment; technical guidance is widely available through the AICPA and other third party sources. In index of reference materials and links is provided at the end of this presentation.
Introduction

Why is this important?

**CPAs in public practice**
- Improve professional competency through an enhanced understanding of the current business environment and trends related to SOC reporting
- Manage engagement risk by understanding the scope, intent, and implications of SOC reporting related to various services provided to clients
- Advise clients on risk management strategies and practices that can be leveraged through SOC reporting
- Identify current and future value-added opportunities for clients

**CPAs in business**
- Enhance breadth and depth of understanding of the current business environment related to SOC reporting, your industry, and your unique business circumstances
- Understand the implications of SOC reporting as it relates to your operations and your business relationships with third parties
- Identify strengths, weaknesses, opportunities, and threats associated with your business and SOC reporting trends
Drivers of Change – the Changing Business and Tech Landscape

The changing technology landscape

- Increased availability and decreased cost of high-speed data exchange and processing power
- Widespread availability of wireless connectivity
- Virtualization tools and distributed computing
- Software-as-a-Service and availability of cloud services
- The nature of hardware devices and connectivity

The changing business environment

- Remote workforces
- Increasing reliance on third-party service-based technology platforms
- Continued trend of data-related services and business process outsourcing
- Complexity of data exchange relationships amongst vendors, partners, and customers
- The rise of crowd-based platforms
- Increasing awareness of risks related to data privacy and security
- Diversity of hardware and software deployed in the workplace
Drivers of Change – the Changing Business and Tech Landscape

Perspective

The data processing, internet publishing, and other information services sector increased its contribution to GDP threefold between 2007 and 2017, ballooning from a value-add of $65.2 billion to $263.6 billion; data processing, internet publishing, and other information services are the fastest-growing segments of services-producing industries.

("Trends in the Information Technology Sector"; Henry-Nickie, Frimpong, Sun; 3/29/19; Brookings)

SOC Reporting: Keeping Pace with a Changing Business Landscape

Drivers of Change – the Changing Business and Tech Landscape

Perspective

Worldwide IT spending is projected to total $3.8 trillion in 2019, an increase of 3.2 percent from expected spending of $3.7 trillion in 2018, according to the latest forecast by Gartner, Inc.; “While currency volatility and the potential for trade wars are still playing a part in the outlook for IT spending, it is the shift from ownership to service that is sending ripples through every segment of the forecast,” said John-David Lovelock, research vice president at Gartner. “What this signals, for example, is more enterprise use of cloud services — instead of buying their own servers, they are turning to the cloud. As enterprises continue their digital transformation efforts, shifting to ‘pay for use’ will continue. This sets enterprises up to deal with the sustained and rapid change that underscores digital business.”

("Gartner Says Global IT Spending to Grow 3.2% in 2019"; Garfinkel; 10/17/18; Gartner)

SOC Reporting: Keeping Pace with a Changing Business Landscape
Drivers of Change – the Changing Business and Tech Landscape

Perspective

The cost of a data breach for 2018 was reported at $148 per record.

("Cost of a Data Breach Study”; 4/2019; Ponemon)

SOC Reporting: Keeping Pace with a Changing Business Landscape

A study conducted by IWG based on the insights of over 18,000 business people across 96 companies found that every week 70% of employees are working at least one day a week somewhere other than the office, more than half (53%) work remotely for half of the week or more, whilst more than one in 10 (11%) people work outside of their company's main office location five times a week.

("Annual IWG Global Workplace Survey”; 5/20/18; IWG)

SOC Reporting: Keeping Pace with a Changing Business Landscape
Drivers of Change – the Changing Business and Tech Landscape

Why is this relevant to SOC reporting?

• The rapidly changing business and technology environment promulgates changes in information risk profiles and the needs of businesses
  • Increased awareness has shifted focus
  • Risk-based demand from a variety of stakeholders for information-related assurance has increased
  • The need for trusted and verified information exchanges in business has increased
  • The nature of data-driven relationships, combined with awareness, has driven demand for more diverse options for attaining information assurance
• These factors plus many more have driven the changes to SOC reporting – from SAS 70 to what we have today
• More changes will come at a faster pace; the challenge will be the accounting profession’s ability to adapt quickly with options for meeting demand, and educating business stakeholders and accounting professionals alike

SOC Reporting: Keeping Pace with a Changing Business Landscape

Trends Related to Information Assurance, Trust, and Regulatory Compliance
Trends Related to Information Assurance, Trust, and Regulatory Compliance

The dawn of information assurance
- The early days of information systems and assurance, combined with business process outsourcing and internal control over financial reporting, set the stage for SAS No. 70, Service Organizations
- The AICPA was an early innovator, extending the COSO framework applied to internal control over financial reporting (ICFR) of a reporting entity to its relevant service providers
- The demands of multiple external auditors on service organizations spawned the concept of a standard intended to report once for many to rely upon
- This stood for many years as a de facto reporting standard for independent information assurance that user entities could rely upon to evaluate their vendors
- Over time, it was increasingly used for purposes other than ICFR

SOC Reporting: Keeping Pace with a Changing Business Landscape

Trends Related to Information Assurance, Trust, and Regulatory Compliance

Increasing needs of business
- With the internet and technology boom of the late 1990s and early 2000s, the appetite for information assurance increased substantially
- This was not only at service organizations, but with other vested entities
  - The impact of the HIPAA rule (1996) and its extension to business associates became increasingly relevant, resulting in the HITECH and Omnibus modifications
  - Credit card frauds prompted Visa to implement the CISP program in 1990; this, in turn, ignited an industry initiative that would result in the PCI Data Security Standard and PCI Security Standards Counsel that applies to virtually all merchants and service providers
  - Various other regulatory, industry, and independent bodies began developing information security-related compliance standards that could be used as reporting frameworks, mostly specific to certain classifications of data (HITRUST, FISMA, Microsoft SSPA, Experian E3PA, FedRAMP to name a few)
Trends Related to Information Assurance, Trust, and Regulatory Compliance

AICPA – responding to changing needs

• The AICPA responded with initiatives including SysTrust and WebTrust in collaboration with the CICA
• The specified users and the limited reporting scope inhibited broad acceptance of these initiatives
• Accordingly, the intended use of audits conducted under SAS No. 70 was increasingly abused, as many industries adopted this as a “checkbox” standard for information assurance, regardless of the scope of data and the relationship between service provider and customer
• Recognizing both the issues revolving around SAS No. 70, as well as unfulfilled market demand, the AICPA superseded SAS No. 70 with SOC 1 (SSAE 16), and introduced the concept of SOC 2 (AT 101)

SOC Reporting: Keeping Pace with a Changing Business Landscape

Trends Related to Information Assurance, Trust, and Regulatory Compliance

AICPA – responding to changing needs (cont.)

• SOC referred to Service Organization Controls
• SSAE 16 introduced much needed changes for reporting on controls related to ICFR at a service organization
• SOC 2 introduced a clear method for meeting information assurance needs associated with service organizations while addressing the shortcomings of SysTrust and WebTrust
• SOC 2 adoption was slow at first, but after several years overshadowed SOC 1 reporting
• SSAE 18 later superseded SSAE 16 and incorporated the guidance for SOC 2 reporting
• The increasing complexity of the business and technology environment, combined with increasing demand, promulgated the rebranding of SOC reporting from “Service Organization Controls” to “System and Organization Controls”, thereby broadening the applicability of the standards to accommodate a broader base of unique and quickly changing needs

SOC Reporting: Keeping Pace with a Changing Business Landscape
Trends Related to Information Assurance, Trust, and Regulatory Compliance

Current business context of information assurance, trust, and regulatory compliance

• All businesses have regulatory, industry, or contractual requirements for securing information
• Risk and awareness have increased demand for third party assurance by many stakeholders beyond service organizations
• Managing risk and compliance requirements has become a significant exercise from both the standpoints of internal control and reporting
• Cost and operational impact are major factors for most businesses
• Risk, compliance, and information security programs are now a necessity for a vastly greater number of organizations that just ten years ago

SOC Reporting: Keeping Pace with a Changing Business Landscape

Trends Related to Information Assurance, Trust, and Regulatory Compliance

Current business context of information assurance, trust, and regulatory compliance (cont.)

• Point of reference – in 2009 less than 10% of 360 Advanced clients were engaged to perform MORE THAN one type of information assurance engagement; in 2019 less than 10% of 360 Advanced clients are engaged to perform ONLY one type of information assurance engagement
• CPAs in public practice must be able to leverage a variety of frameworks to deliver value to their clients without redundant efforts
• Businesses cannot afford operationally, financially, or competitively to have multiple service providers or teams performing information assurance engagements for the same environment or scope of services
• In the past, service providers utilized SAS No. 70 reports or other information assurance reports as competitive advantages; today, these are benchmark requirements to do business in many industries

SOC Reporting: Keeping Pace with a Changing Business Landscape
Current State of SOC Reporting

Current state of SOC reporting
• SOC for Service Organizations
  • SOC 1: ICFR
  • SOC 2: Trust Services Criteria
    • SOC 2 + HITRUST
    • SOC 2 + CSA STAR
  • SOC 3: Trust Services Criteria General Use Report
• SOC for Cybersecurity
• SOC for Supply Chain

SOC Reporting: Keeping Pace with a Changing Business Landscape
Current State of SOC Reporting

SOC for Service Organizations

Per the AICPA: “Internal control reports on the services provided by a service organization providing valuable information that users need to assess and address the risks associated with an outsourced service”

SOC Reporting: Keeping Pace with a Changing Business Landscape
Current State of SOC Reporting

**SOC for Service Organizations – SOC 2: Trust Service Criteria**
- Intended for customers to establish confidence and gain trust in a service organization’s system
- Provides insights into processing controls at the service organization
- Focus on service organization’s service commitments and system requirements (often defined in MSAs and SLAs)
- Requirement to disclose security incidents / breaches
- Renewed focus on governance, risk management, and fraud risk
- Utilizes the Trust Services Categories (TSC)
  - Security
  - Availability
  - Processing Integrity
  - Confidentiality
  - Privacy

**SOC for Service Organizations – SOC 2: SOC 2 +**
- Utilizes the Trust Services Categories in conjunction with other third party standards
- + HITRUST – bridging the gap with the HITRUST alliance and integrating efforts
- + CSA STAR – working with the Cloud Security Alliance Security Trust Assurance and Risk program for cloud security
- + ??? – HIPAA, others...
Current State of SOC Reporting

SOC for Service Organizations – SOC 3: Trust Services Criteria for General Use Report
• Essentially SOC 2 with a reduced level of detail
• Intended for general distribution with reduced risk that the information contained therein may be used against the organization competitively or to compromise the Service Organization’s system

SOC for Cyber Security
• General use report for a broad group of stakeholders
• Applicable for any organization (not limited to service organizations)
• Contents focus on the entity’s cybersecurity risk management program
• TSC may be used as control criteria, but may also use other suitable criteria such as NIST or ISO 27001
Current State of SOC Reporting

SOC for Supply Chain

• Currently in exposure draft
• Intended to provide useful information to enable users of goods produced, manufactured, or distributed by an entity to better understand and manage the risks, including cybersecurity risks, arising from their business relationship with the entity
• Specified users include customers and similar downstream entities, business partners, nonregulatory standard-setting bodies representing the entities membership
• Evaluated using the TSC in the context of the entities objectives (referred to as system objectives)
What’s Next?

Future technology landscape
• SaaS and cloud-based solutions expected to increase
• The internet of things – security and privacy
• The role of information warfare
• Computer learning; automation
• The user profile and the role data will play

What’s Next?

Future business landscape
• Increasing regulatory pressures
• Streamlining of information assurance demands (example, HITRUST)
• Big data; more data
• Shifting of risk – tokenization and vaulting
• Continued outsourcing and increased reliance on third parties for data security
What’s Next?

Future regulatory landscape
- Privacy alarm – GDPR; California privacy act
- Rise of regional data protectionist policies – transmission and storage of data
- Challenges associated with localized laws and regulations
- Offensive and defensive warfare tactics
  - Hardware
  - Software
  - Trade restrictions
- Measures to prevent total collapse in declared warfare

What’s Next?

Technologies affecting the accounting profession
- Artificial intelligence
- Machine learning
- Robotic automation technologies
- Blockchain
- The accountant of the past and future
What’s Next?

The AICPA’s ability to adapt rapidly and effectively to changing circumstances

• Speed to market
• Standards that are easily adoptable
• Standards that meet the needs of a broad range of stakeholders
• The importance of educating stakeholders
• Integration with other standards, programs, and initiatives
Resources and Reference Materials

360 Advanced

• SOC reporting assurance and advisory services - https://360advanced.com/

General

• **Standard**: AT-C Section 105: Concepts Common to All Attestation Engagements – https://www.aicpa.org/content/dam/aicpa/research/standards/auditattest/downloadedocuments/at-c-00105.pdf
• **Standard**: AT-C Section 205: Examination Engagements – https://www.aicpa.org/content/dam/aicpa/research/standards/auditattest/downloadedocuments/at-c-00205.pdf
Resources and Reference Materials

General (cont.)

- **Reference:** System and Organization Controls: SOC Suite of Services – [https://www.aicpa.org/SOC](https://www.aicpa.org/SOC)
- **Whitepaper:** SOC 2 Examinations and SOC for Cybersecurity Examinations: Understanding the Key Distinctions – [https://www.aicpa.org/content/dam/aicpa/interestareas/frc/assuranceadvisoryservices/downloadabledocuments/Cybersecurity/soc‐2‐vs‐cyber‐whitepaper‐web‐final.pdf](https://www.aicpa.org/content/dam/aicpa/interestareas/frc/assuranceadvisoryservices/downloadabledocuments/Cybersecurity/soc‐2‐vs‐cyber‐whitepaper‐web‐final.pdf)
- **Brochure:** SOC 2 and SOC for Cybersecurity: How they’re different and how they can help – [https://www.aicpastore.com/content/dam/aicpa/interestareas/frc/assuranceadvisoryservices/downloadabledocuments/soc2‐vs‐soc‐for‐cyber‐brochure.pdf](https://www.aicpastore.com/content/dam/aicpa/interestareas/frc/assuranceadvisoryservices/downloadabledocuments/soc2‐vs‐soc‐for‐cyber‐brochure.pdf)

Resources and Reference Materials

SOC 1

- **Guidebook:** Reporting on an Examination of Controls at a Service Organization Relevant to User Entities’ Internal Control Over Financial Reporting (SOC 1) – [https://www.aicpastore.com/ConsultingServices/reporting-on-an-examination-of-controls-at-a-service/PROOVR~PC‐0127910/PC‐0127910.jsp](https://www.aicpastore.com/ConsultingServices/reporting-on-an-examination-of-controls-at-a-service/PROOVR~PC‐0127910/PC‐0127910.jsp)
Resources and Reference Materials

SOC 2, SOC 3

- **Reference**: Trust Services Criteria (TSP 100) – [https://www.aicpa.org/content/dam/aicpa/interestareas/frc/assuranceadvisoryservices/downloadabledocuments/trust-services-criteria.pdf](https://www.aicpa.org/content/dam/aicpa/interestareas/frc/assuranceadvisoryservices/downloadabledocuments/trust-services-criteria.pdf)

SOC Reporting: Keeping Pace with a Changing Business Landscape

Resources and Reference Materials

SOC for Cybersecurity

- **Whitepaper**: SOC for Cybersecurity: A Backgrounder – [https://www.aicpa.org/content/dam/aicpa/interestareas/frc/assuranceadvisoryservices/downloadabledocuments/soc-for-cybersecurity-backgrounder.pdf](https://www.aicpa.org/content/dam/aicpa/interestareas/frc/assuranceadvisoryservices/downloadabledocuments/soc-for-cybersecurity-backgrounder.pdf)

SOC Reporting: Keeping Pace with a Changing Business Landscape
Resources and Reference Materials

SOC for Supply Chains


Questions?

Dan Collins, MBA, CPA
President & CEO
360 Advanced Inc.

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www.360advanced.com
Agenda

- SEC organization and structure
- SEC priorities
- SEC rulemaking
- SEC market risk disclosures
- Non-GAAP measures
- New accounting standards
- Critical audit matters
- SEC review process
- Comment letter trends
- Appendix - Resources
SEC organization and structure

Commissioner
Robert Jackson, Jr. (Term expires 2019)
Commissioner
Hester Peirce (Term expires 2020)
Chairman
Jay Clayton (Term expires 2021)
Commissioner
Elad Roisman (Term expires 2023)
Commissioner
Vacant*

Office of Chief Accountant
Chief Accountant—Wes Bricker

Economic and Risk Analysis
Corporation Finance Director—William Hinman
Investment Management
Trading and Markets
Enforcement

Corp Fin – Office of the Chief Accountant
Chief Accountant—Kyle Moffatt
Industry Assistant Director (AD) Group (11)

*Allison Lee expected to be nominated by the President, subject to Senate confirmation.

SEC priorities

Mission

Protect investors
Facilitate capital formation
Maintain fair, orderly and efficient markets

Rulemaking
Market risk disclosures
Non-GAAP – Tailored accounting measures
New accounting standards
Critical audit matters
SEC rulemaking

**Final rules issued**
- Smaller Reporting Company Definition
- Inline XBRL
- Disclosure Update and Simplification
- FAST Act modernization and simplification

**Proposed rules**
- Guarantor financial information
- Acquired business financial information
- Accelerated filer definition

**Requests for comment**
- Earnings releases and quarterly reports (request for comment)

*Rule 3-13 waivers may be considered if consistent with investor protection*

---

**SEC rulemaking**

FAST Act modernization and simplification

- Final rule – Generally effective May 2, 2019

**Key provisions**

- MD&A – May reference prior filings for discussion of third back year
- Redaction of confidential information simplified
- Description of physical properties required only to the extent material
- Principles based approach to risk factor - removed examples
- Adds hyperlinks and cross-references

- Changes to the cover page of certain forms:
  - Disclosure of the trading symbol for each class of registered securities on cover pages of Forms 10-K, 10-Q, and 8-K
  - iXBRL tagging of cover page (effective when iXBRL effective)
## SEC rulemaking

**Disclosure Update and Simplification - (DUST-R)**

- **Final rule – Effective November 5, 2018**

### Selected Disclosure Requirements Eliminated

<table>
<thead>
<tr>
<th>Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Business section disclosures:</td>
</tr>
<tr>
<td>- Disclosure of amount spent on R&amp;D</td>
</tr>
<tr>
<td>- Segment financial information</td>
</tr>
<tr>
<td>- Financial information by geographic area</td>
</tr>
<tr>
<td>- Ratio of earnings to fixed charges (Reg. S-K Item 503)</td>
</tr>
<tr>
<td>- Replaces high / low share price disclosures with disclosure of ticker symbol</td>
</tr>
</tbody>
</table>

### Selected Disclosure Requirements Added

- For interim periods, Statement of Changes in Shareholders' Equity require YTD and QTD interim periods for current and prior year
- Disclosure alternatives available
  - Stacked separate roll forward for each period
  - Integrated roll forward with subtotals for each period

---

## SEC rulemaking

**Inline XBRL**

- **Final rule - Combine XBRL data currently in exhibits with HTML-encoded report filings**
- **Applicable to operating companies in first Form 10-Q after June 15:**
  - ✓ 2019 for large accelerated filers
  - ✓ 2020 for accelerated filer
  - ✓ 2021 for all other filers
- Front page of Exchange Act reports (i.e., Form 10-K, Form 10-Q) required upon adoption
SEC rulemaking
Proposed Rule - Amendments to Financial Disclosures about Acquired and Disposed Businesses
• Comments Due – 60 days from publication in the Federal Register

<table>
<thead>
<tr>
<th>Proposed Amendment</th>
<th>Current Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment Test – compare GAAP purchase price to the total market value of the registrant’s common equity</td>
<td>Investment Test – compare GAAP purchase price to the total registrant’s total assets</td>
</tr>
<tr>
<td>Income Test –</td>
<td>Income test</td>
</tr>
<tr>
<td>• Adds a new revenue component</td>
<td>• No revenue component</td>
</tr>
<tr>
<td>• Based on income or loss from continuing operations after income taxes</td>
<td>• Based on income or loss from continuing operations before income taxes</td>
</tr>
<tr>
<td>• Must meet both test – lower of the two determines number of periods of F/S</td>
<td></td>
</tr>
<tr>
<td>• Several clarifications on performing test when there are losses</td>
<td></td>
</tr>
<tr>
<td>Requires up to two years of F/S depending on significance / bright line significance thresholds retained</td>
<td>Requires up to three years of F/S depending on significance</td>
</tr>
<tr>
<td>Acquiree F/S do not need to be presented a registration statement / proxy after they are in audited results for a year</td>
<td>If major significance (over 70%) must continue to present acquiree F/S</td>
</tr>
<tr>
<td>Simplifies pro forma requirements and allows pro formas to present reasonably estimable synergies and other transaction effects</td>
<td>Pro forma adjustments must be (1) directly attributable, (2) have a continuing impact and (3) factually supportable</td>
</tr>
</tbody>
</table>

Market risk disclosures
Cybersecurity

Continued area of focus from the SEC staff
Change from prevention mindset to forward-looking, proactive perspective is seen as essential
Re-assess cybersecurity disclosures as risks evolve and incidents occur
Areas of emphasis include:
• Disclosure controls and procedures at the appropriate levels in the organization
• Insider trading policies
• Disclosures on the role of the Board of Directors in cyber risk oversight
**Market risk disclosures**

**Cybersecurity - 2018 Cyber report**

- Focuses on business email compromises (BEC) - fake executive and vendor emails
- Since 2014 BECs have caused over $5 billion in losses
- Summarizes findings from investigations of 9 registrants (no enforcement action taken)
- Encourages registrants to evaluate whether internal accounting controls are sufficient to safeguard assets:
  - Adapt to changing threats
  - Importance of training and user awareness

**Market risk disclosures**

**Brexit**

- Financial and business risks may be not well understood or underestimated
- Transparent, company-specific disclosures:
  - Risk factors
  - Management’s discussion & analysis
- Consider accounting impacts:
  - Asset valuations
  - Income taxes
- Disclosures expected to evolve as more information becomes available
Market risk disclosures
Transition From LIBOR

- Targeted phase-out date in 2021
- FASB has added SOFR as a benchmark interest rate for hedging
- May impact financing, hedging, and other activities
- Action items to consider:
  - Inventory contracts linked to Libor, extending past 2021
  - Understand the fallback language in all existing contracts
  - Evaluate the need for disclosures in MD&A, risk factors or liquidity and capital resources

Non-GAAP measures

- Overall level of comments has declined
- Focus on Disclosure Controls and Procedures Continues
  - Same quality as GAAP controls
  - Identifying and correcting errors
- Comments continue regarding:
  - Individually tailored accounting
  - Prominence
- Adjustments for impact of:
  - Acquired intangibles
  - Adoption of new standards
New accounting standards
Implementation considerations

ICFR
Transition disclosures (SAB 74)
New disclosure requirements
Reasonable judgment
Audit committee involvement

New accounting standards
Revenue comment letter themes

Significant judgments ~40%
- Identification of performance obligations
- Determination and allocation of transaction price
- Identification of measure of progress
- Disaggregation

Example SEC comment
"...disclose why the method used [for over time performance obligations] provides a faithful depiction of the transfer of goods or services..."

Performance obligations ~20%
- Point in time vs. over time
- Disclosure of significant payment terms
- Significant financing components
- Principal vs. agent

Example SEC comment
"...Tell us how you considered the guidance in [ASC 606] in determining the point in time at which you recognize revenue and disclose any significant judgements made..."

Contract Costs ~10%
- Method being used to amortize the costs
- How the amortization period correlates with the period of benefit
- Consideration of renewals

Example SEC comment
"...please revise to disclose the method by which you amortize the initial commission costs over the five-year period of benefit..."

Bold items highlighted at the 2018 AICPA Conference

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New accounting standards
Lease implementation

- Capturing known leases
- Internal controls over financial reporting—in transition and ongoing
- Embedded lease identification & completeness
- Software solutions and workarounds

Disclosure considerations:
- Significant judgments
- ASC 840 comparative disclosures
- Annual disclosures required in Form 10-Q in year of adoption

New accounting standards
Credit losses

Scope
1. Impacts broader than financial services entities
2. Accounts receivable, lessor receivables, contract assets, etc.

Transition
2. Effective in 2020
3. Modified retrospective method effective beginning of the first reporting period of adoption

Disclosure
3. Credit quality indicators disaggregated by year of origination for five years
Critical audit matters

SEC Views on Implementation

- **Goal:** Improved information for investors
- **Scope:** Not required for emerging growth companies, broker dealers, non-BDC investment companies, or stock/savings plans
- **Effective date:**
  - Large accelerated and accelerated filers — Fiscal years ending on or after June 30, 2019
  - All other companies — Fiscal years ending on or after December 15, 2020.
- Important for management and audit committees to stay engaged with their auditors on CAMs — during and after implementation
- SEC closely monitoring implementation similar to new accounting standards
- No bright line on number of CAMs

SEC review process

- All issuers reviewed at least once every 3 years
- Focus on registrants that comprise a large portion of the market cap
- Percentage of issuers reviewed in 2018: 57%
- Not all reviews result in comment letters
- Comments are posted to EDGAR 20 days after completion of review

**Reminders:**
- Staff is listening to analyst/earnings calls, reviewing press releases, websites
- May call registrants to address time-sensitive matters or resolve open comments
Comment letter trends

Twelve months ended July 31, 2018

<table>
<thead>
<tr>
<th>Topic</th>
<th>Percentage of all reviews</th>
<th>Rank</th>
<th>Change in rank from prior year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-GAAP measures</td>
<td>30%</td>
<td>1</td>
<td>-</td>
</tr>
<tr>
<td>MD&amp;A</td>
<td>2</td>
<td></td>
<td>-</td>
</tr>
<tr>
<td>Results of operations</td>
<td>13%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Critical accounting policies and estimates</td>
<td>6%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liquidity</td>
<td>5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contractual obligations</td>
<td>1%</td>
<td>3</td>
<td>-</td>
</tr>
<tr>
<td>Fair value</td>
<td>14%</td>
<td>3</td>
<td>1</td>
</tr>
<tr>
<td>Revenue recognition</td>
<td>11%</td>
<td>4</td>
<td>1</td>
</tr>
<tr>
<td>State sponsors of terrorism</td>
<td>10%</td>
<td>5</td>
<td>3</td>
</tr>
<tr>
<td>Signatures, exhibits and agreements</td>
<td>9%</td>
<td>6</td>
<td>3</td>
</tr>
<tr>
<td>Segment reporting</td>
<td>9%</td>
<td>7</td>
<td>3</td>
</tr>
<tr>
<td>Income taxes</td>
<td>8%</td>
<td>8</td>
<td>1</td>
</tr>
<tr>
<td>Intangible assets and goodwill</td>
<td>8%</td>
<td>9</td>
<td>3</td>
</tr>
<tr>
<td>Acquisitions, mergers and business combinations</td>
<td>7%</td>
<td>10</td>
<td>-</td>
</tr>
</tbody>
</table>

Note: Comment Letter trend information was derived from data provided by Audit Analytics based on the percentage of all comment-letter-yielding Form 10-K and 10-Q reviews that include a comment on topic.

Comment letter trends

Areas of focus

**Non-GAAP measures**
- Prominence
- Nature of adjustments (i.e. misleading)
- Disclosure of the purpose and relevance of the measure
- Reconciliations
- Key performance indicators

**MD&A**
- Tell management’s story
- Quantifying multiple impacts
- Estimates in critical accounting policies
- Disclosures related to income taxes

**Fair value**
- Valuation techniques and inputs used
- Disclosures for recurring and nonrecurring fair value measurements
- Use of third-party pricing services
Comment letter trends
Areas of focus

Revenue Recognition
- Completeness and consistency of disclosures
- Gross vs. net
- Identification of performance obligations

State sponsors of terrorism
- Nature and extent of contracts with Iran, North Korea, Sudan, and Syria
- Quantitative and qualitative factors regarding such activities

Segments
- Identification of operation segments
- Changes in reportable segments
- Aggregation of operating segments still a focus—consider both quantitative and qualitative factors
- Entity-wide disclosures

Income Taxes
- Potential tax and liquidity ramifications related to the repatriation of foreign earnings
- Valuation Allowance
- Rate reconciliation
  - Appropriate breakout (and descriptions of) adjustments
- Unrecognized tax benefits

Goodwill and intangible assets
- Early warning disclosures
- Valuation Assumptions and sensitivity (FRM 9510)
- Specific events that caused the impairment—"why now"

Business combinations
- Asset vs. business acquisition
- Identification of the accounting acquirer
- Allocation of purchase price to goodwill and identified intangible assets
- Contingent consideration arrangements
- Omission of required disclosures
Comment letter trends

Reminders about communications with the SEC

**SEC comment letter process**
SEC staff views the comment letter process as a dialogue between the registrant and the SEC:
- Just because the staff asks a question does not mean that it has reached a conclusion or that a change is required
- Registrant should not agree to include a disclosure in future filings solely to expedite the completion of a review
- Registrant should communicate, early on, if it believes that a comment concerns an immaterial matter
- Registrants should be cautious in analogizing to other registrants’ fact patterns
- Registrants should give the SEC time to appropriately evaluate substantive new information during the review process

**Prefiling letter process**
- **Division of Corporation Finance’s OCA**
  - Request for interpretations, accommodations, or waivers of financial reporting and disclosure requirements
- **SEC’s Office of the Chief Accountant**
  - Requests for accounting, financial reporting, and auditing interpretations

**Staff reminders:**
- Be concise
- Focus on relevant facts
- Provide solutions and adequate support for the proposals
- Show letter to auditors and have them weigh in before sending

Appendix – Resources

Select Deloitte Roadmaps

- **A Roadmap To SEC Comment Letters – Including Industry Insights**
  - November 2018
  - Update of SEC’s strategic priorities
  - Expanded presentation of comment letter statistics

- **A Roadmap to Non-GAAP Financial Measures**
  - Combines SEC guidance with interpretations and examples
  - Disclosure controls and procedures

- **A Roadmap to SEC Reporting Considerations for Equity Method Investments**
  - Presentation of separate financial statements and summarized financial information
  - Measuring significance

- **A Roadmap to SEC Reporting Considerations for Business Combinations**
  - Requirements for separate financial statements and pro forma information
  - Measuring significance

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GDPR and the Data Privacy Revolution

USF Continuing Education
Friday, May 17, 2019

PRESENTERS

Leslie Larson
Lexy Schwartz

DISCLAIMER
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- The opinions expressed are ours and not those of Cott Corporation or any of its subsidiaries.
COTT OVERVIEW

Leading route based North American and European water, coffee, tea, and filtration service provider within the Home and Office Delivery, food service, convenience, and hospitality industries.

Operations in the US, Canada, Israel, and 17 European countries

>$2.4bn (2019E) Annual Sales

>2.4mm customers served annually

>3,600 direct-to-consumer routes

>60 manufacturing sites

>360 branch distribution and warehouse facilities

QUIZ QUESTIONS

- If an individual requests that you delete the information you have collected about them, you are required to do so.

- A business email address is considered personal information.

- You can telemarket from a blocked number, leave a message, and not include a callback phone number.

- If someone registers for a course via a webform, you can send them marketing materials about your company.
BACKGROUND: WHAT IS GDPR?

After over 4 years of negotiations, the **EU General Data Protection Regulation (GDPR)** replaced the 1998 European Data Protection Directive when it became legally effective in all EU member states on 25 May 2018.

The purpose of GDPR is to overhaul, unify, and strengthen data protection for all individuals within the EU. It also addresses the export of personal data outside the EU and applies to non-EU countries who supply to EU citizens.

The GDPR sets forth 99 Articles which define compliance requirements.

Under the GDPR, individuals have considerably strengthened rights to privacy that they can enforce directly against organizations. Individuals are now granted rights around the usage, storage, accuracy, and erasure of personal data.

GDPR DEFINITIONS

- **Personal Data / Personally Identifiable Information (PII)** – data which identifies an individual such as name, email address, phone number, or photo
- **Retention Period** – time for which data is retained in order to comply with local regulations and / or legal basis (including purpose for which it was collected)
- **Anonymization** – process of encrypting or removing personally identifiable data from data records
- **Pseudonymization** – process of replacing identifying or sensitive data with a token or pseudonym
- **Subject Access Requests (SARs)** – GDPR empowers individuals to request information from companies which hold data on them and to receive formal answers within 30 days
- **Data Subject** – identified or identifiable living natural person (includes employees, customers, and suppliers)
- **Data Controller** – the legal person or business entity that decides the purposes for which and the manner in which personal data are processed
- **Data Processor** – the legal person or business entity that processes personal data on behalf of data controller
SEVEN KEY GDPR PRINCIPLES OF DATA PRIVACY

1. Personal data will be obtained and processed lawfully, fairly, and with the data subject’s understanding

2. Personal data will be collected for a specified, explicit, and legitimate purpose, and not processed outside of this purpose

3. Personal data will be limited to what is necessary for the purpose for which it is processed

4. Personal data will be accurate and kept up to date where necessary and deleted or corrected if inaccurate

5. Personal data should not be kept longer than is necessary

6. Personal data should be processed in a manner that ensures appropriate security, including protection against unauthorized or unlawful processing and against accidental loss, destruction, or damage

7. Our company will be held accountable for demonstrating compliance with their obligations under the GDPR

OVERVIEW OF BUSINESS OBLIGATIONS

- Consent
- Contract
- Legal Obligation
- Vital Interest
- Public Interest
- Legitimate interest of the controller(*)

(*) Legitimate interest of the controller must be balanced against the interests, rights, and freedoms of the data subject.
OVERVIEW OF DATA SUBJECT RIGHTS

The table below summarizes Data Subject Rights and the associated GDPR Article

<table>
<thead>
<tr>
<th>Data Subject Right</th>
<th>Article</th>
<th>Summary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Access</td>
<td>Article 15</td>
<td>Right to obtain a copy of personal data and certain other information</td>
</tr>
<tr>
<td>Rectification</td>
<td>Article 16</td>
<td>Right to have personal data corrected if it is inaccurate or incomplete</td>
</tr>
<tr>
<td>Erasure</td>
<td>Article 17</td>
<td>Right to request deletion or removal of data (there are exceptions)</td>
</tr>
<tr>
<td>Restriction</td>
<td>Article 18</td>
<td>Right to ‘block’ or suppress further use of personal data</td>
</tr>
<tr>
<td>Objection to processing for direct marketing</td>
<td>Article 21 (2)</td>
<td>Right to object to processing for direct marketing purposes</td>
</tr>
</tbody>
</table>

PATH TO IMPLEMENTATION

Step 1: Create a Project Team

- Identify Data Stewards within each market to drive implementation tasks and to carry out ongoing responsibilities supporting the objectives and compliance activities of the company’s GDPR program

- Establish a Steering Committee with representatives from Legal, HR, IT, Sales & Marketing, Compliance, and External Advisors
  - Define a recurring meeting schedule

- Maintain project visibility among Executives including the Audit Committee and Board of Directors
  - Communicate program status often via Management reporting and Audit Committee and Board of Directors meetings
Step 2: Identify the personal data that you collect and process as well as its purpose and the legal basis for processing the data

Data Mapping

- Identify the business owners of the data
  - TALK TO EVERYONE!
- Identify systems or platforms used to hold, process, and collect personal data
- Identify the data formats (e.g. paper or electronic) and data flow
- Determine whether data is transferred outside of the organization and how
- Identify data storage locations (e.g. on-premise, cloud-based, and / or third-party provider)
- Identify which countries store the data
- Define overall data classification (e.g. confidential, public)
- Define current security measures / access controls and retention protocols
- Document all findings and determine which of the data you hold is truly required

Step 3: Notify employees, customers, and other data subjects about the personal data you collect and process

Employee awareness

- Develop an Employee Privacy Notice ("EPN") to inform employees about personal data processed by the company and their rights in controlling how personal data is used
- Circulate the EPN across all GDPR markets in local language for signed acknowledgement

Customer awareness

- Issue proactive GDPR communications to all active customers
  - These communications address GDPR and the company’s commitment to data privacy
Step 3: Notify employees, customers, and other data subjects about the personal data you collect and process – continued

Update Websites

✓ "Request for Quote" Web Forms  
  – Allow customers to explicitly consent to receive marketing materials (or not!)
✓ Cookies Banner
✓ Cookies Policy  
  – Details on how the company uses cookies, including the type and purpose of the cookies used on websites, as well as user rights to disable cookies
✓ Privacy Policy  
  – Provides details on how the company uses, protects, and retains personal data that users voluntarily provide when interacting with our websites as well as how users can inquire on processing or protection of their own personal data  
  – Outlines user / data subject rights with respect to data collection and processing

Step 4: Establish data retention guidelines

✓ Collaborate with Legal and GDPR advisors  
✓ Define market specific retention requirements  
✓ Initiate "spring cleaning" activities  
✓ Consider system configurations necessary to support retention requirements

Step 5: Develop internal policies and procedures

✓ Data Privacy Policy  
✓ Information Security Policy  
✓ Information Security Incident Management Procedures  
✓ GDPR Incident Notification Plan  
✓ Information Security Policy Guidelines
Step 6: Secure the personal data you process

- Anonymize or Pseudonymize
- Review system access
- Review physical security access

Step 7: GDPR considerations for M&A

- Due diligence
  - Can the target company demonstrate GDPR compliance?
  - Does the target company transfer or process data outside the EU?
  - How are leads obtained?
  - Only request minimally required personal data (e.g. number of employees without employee names)

Step 8: GDPR considerations for Sales & Marketing

- Assess Sales & Marketing activities including third-party relationships
- Develop Sales & Marketing Procedures for Customer and Lead Communications
  - Guidelines differ, in some cases, for Business-To-Consumer (“B2C”) and Business-To-Business (“B2B”) commerce transactions
  - Sole proprietors are considered B2C under the GDPR
  - Opt-in and opt-out preferences for marketing communications must be managed for customers and leads
  - Communication preferences should be logged within company systems
  - Marketing communications should be issued according to opt-in / opt-out preferences
  - Both internal and external ‘Do Not Contact’ lists must be consulted prior to issuing marketing communications
  - Electronic marketing communications including SMS, email, automated calls, and online / website portal must contain an option to opt-out or unsubscribe
  - Develop scripts and FAQs for Call Center and customer-facing roles
Step 9: GDPR considerations for Human Resources and Payroll

- Apply data retention requirements to both paper and system records
- Verify GDPR compliance of third-party providers
- Include the Employee Privacy Notice within new hire packages
- Continue to educate employees about the GDPR

Step 10: Establish vendor procedures

- Assess vendor access and handling of personal data
- Categorize into tiers to identify high risk vs. low risk vendors
- Develop GDPR contract templates for new vendor contracts

Step 11: Establish a secured central repository for all GDPR documentation (e.g. SharePoint)

- Data registers
- Employee Privacy Notice
- GDPR FAQs and Contact Cards
- Call Center scripts
- Procedure for handling subject access requests
- Internal Policies and Procedures
- Contract templates and other Legal documents
- GDPR Handbook
  - An overview of the proper processing / logging and handling of data subject requests
  - Outlines the rights that data subjects have on the usage, storage, accuracy, and erasure of their personal data (Data Subject Rights)
  - Standard response templates for the handling of data subject requests that are most relevant within the business
Step 12: Ensure a sustainable process

- Privacy by Design and Default
- Data Protection Impact Assessments ("DPIA")
- Define a GDPR Compliance Audit Program and Governance Framework
- Establish a GDPR Governance Committee

**PRIVACY BY DESIGN AND DEFAULT**

GDPR Key Requirement: "Companies need to place data protection at the core of all systems and processes."

Designing business process with data protection in mind from the outset, including the seven key principles, can be done by:

- Maintaining security and restricting access to the data
- Making sure we are open and transparent with individuals
- Only retaining personal data for the period needed
- Complying with cross-border transfer requirements

We must keep records of all processing of personal information
At the core of our Data Protection by Design and by Default approach is the Data Protection Impact Assessment (DPIA) process. Every new initiative or processing activity involving personal data must be documented on the DPIA screening form.

The DPIA screening form is a key component of the Data Privacy Policy and is available on the secured central repository.

It should be completed by IT, HR, or Project Manager (whoever is responsible for the new business initiative that might involve personal data).

Staff should contact their Data Steward or Compliance with any questions.

We must conduct DPIA screening on all new processing activities.

Establish preliminary acceptance criteria and the conditions that must be satisfied to enable acceptance by project stakeholders.

Fulfillment of these conditions indicates that an activity is complete.

- The company has a repeatable process that enables the company to respond to data subject requests to:
  - Understand what data is retained and how it is used by the company, and to request access to that data
  - Have inaccurate personal data rectified or portions of data erased
  - Have all personal data erased (i.e. “right to be forgotten”) where the company no longer has lawful basis to retain such data
  - Restrict processing of personal data

- The company employees are (1) aware of and (2) accountable for restrictions regarding the identification, access, duplication, modification, or transfer of personal data

- The company management can report a breach of EU resident data to the appropriate DPA(s) within 72 hours of becoming aware of it, including breaches affecting third-party service providers acting as data processors

- The company management has a repeatable process for identifying and disposing of EU personal data for which it has no lawful basis to maintain

- The company management has a repeatable process for conducting privacy impact analyses for any activity that may involve the collection and / or processing of personal data

- The company management can demonstrate its data protection program to an external party (e.g. a data protection authority)

- The company management has integrated GDPR compliance into its enterprise security and other corporate compliance programs
OPERATIONAL BENEFITS FROM THE LAW

Longer-term benefits that can be derived from a sustained focus

- Increased cross-market and cross-functional interaction
- Consistency of customer-facing processes
- Customer centricity
- Greater customer confidence
- Improved information security
- Synergies and cost savings
- Reduction in data footprint
- Reduced legal exposure

THE RISK OF NON-COMPLIANCE

GDPR brings substantial increases in regulatory risk and sanctions

General Data Protection Regulation

- Severe economic sanctions (Up to €20 million or 4% of global annual turnover, whichever is greater)
- Non-economic sanctions
- Reputational damage
- Litigation (e.g., class actions)
- Prohibition of data processing
- Suspension of international data transfers
- Data breach notification (to both Data Protection Authorities (DPAs) and data subjects)
Apply Key Principles

Collect personal data with clearly defined purpose, and don’t use them for something else

“"The less risk your activities pose to personal data, the less you have to do”"

Don’t collect more data than you need

WHY SHOULD I CARE?
Gartner identified privacy regulation as the Top Emerging Risk in Q1 2019

State-level efforts to pass privacy laws have increased with several members of Congress introducing bills in the past year

- Consumer Data Protection Act of 2018
- Innovative and Ethical Data Use Act of 2018
- Data Care Act of 2018
- Internet Bill of Rights of 2018
- Social Media Privacy and Consumer Rights Act of 2018

California Consumer Privacy Act of 2018 was introduced and approved in June 2018
- Current CCPA effective date is January 1, 2020 with an enforcement date of July 1, 2020 and a lookback date of January 1, 2019

CCPA DEFINITIONS

**Personal Information** – any information that directly or indirectly identifies, relates to, describes, or can reasonably be associated with or linked to a consumer or household

**Consumer** – any natural person who is a California resident (as defined in tax regulations) including employees, patients, tenants, students, parents, children, etc.
- AB 25 exempts employees from definition

**De-identified** – data that cannot be linked or reasonably linkable to a particular individual
- 2012 FTC report standard (AB 873)

**Sale** – broadly includes selling, providing, making available, or disclosing a consumer’s personal information in exchange for monetary or other valuable consideration
CCPA KEY RIGHTS FOR CALIFORNIA RESIDENTS

Under the CCPA, organizations must guarantee the following specific, enumerated rights to California consumers – all of which are operationally complex:

- Notice at or before the time of collection about what is collected and its uses
- The right to know whether their personal information is sold or disclosed and to what sorts of entities
- The right to say no to the “sale” / monetization of their personal information
- The right to access their personal information in portable form
- The right to obtain deletion of their personal information
- The right against unreasonably different treatment for exercising any of the above rights

KEY COMPONENTS OF CCPA

- **Individual Rights** – access, deletion, and portability of personal information. Businesses must disclose information about how they handled individuals’ personal information in the preceding 12 months
- **Mandatory Opt-Out** – businesses must provide clear and conspicuous “Do Not Sell My Personal Information” link on homepage and a toll-free number for opt-out requests
  - for consumers who are under 16 years old, the right not to have their personal information sold absent their, or their parents’, opt-in
- **Enhanced Notices** – businesses must disclose collection and use of personal information. Website Privacy Policies require updates and additional disclosures
- **Updated Contract Terms** – introduces mandatory contract terms for service providers
- **Enforcement Risks** – private right of action and statutory damages in the event of most data breaches of unencrypted or unredacted personal information, if company did not have “reasonable” security
- **Enforcement of privacy provisions by California Attorney General**
  - BUT California AG does not want to be a Privacy Regulator!
KEY COMPONENTS FOR SERVICE PROVIDERS

- Mandatory contract terms for service providers
  - Prohibit recipient from selling the personal information
  - Restrict use and disclosure of personal information to performing the services under contract
  - Restrict maintaining the personal information beyond the expiration of the agreement
  - Include certification of compliance with CCPA

- Absent contractual terms, vendor will be treated as a “third party” for purposes of disclosures and other obligations

- Service providers should be notified of deletion requests

COMMON THEMES FROM GDPR TO CCPA

<table>
<thead>
<tr>
<th>Terms</th>
<th>GDPR</th>
<th>CCPA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal Information</td>
<td>Any information related to an identified or identifiable living natural person</td>
<td>Broader definition includes information that relates to, or is capable of being associated with an individual, device, or household</td>
</tr>
<tr>
<td>Privacy policy/notifications</td>
<td>More detailed notices, layered approach acceptable, distinction between data collected from individual vs. collected from other sources</td>
<td>Less detailed notices + prescriptive as to placement of notices and manner in which it must be received</td>
</tr>
<tr>
<td>Sale of data</td>
<td>No absolute right to opt-out of sale, but conditional rights to object to processing</td>
<td>Right to opt-out of disclosure (sale), subject to limited exceptions; entity must display opt-out link on website</td>
</tr>
<tr>
<td>Individual rights</td>
<td>Right to access with narrow exceptions Conditional rights to erasure, objection and restriction Data portability with broader exceptions and narrower range of in-scope data No explicit right against discrimination but discrimination may render processing unlawful</td>
<td>Right of access limited to data collection in past 12 months; fewer explicit exemptions Conditional right to erasure, no right to object to processing, no right of restriction or amendment Right of portability with fewer exceptions and broader range of in-scope data Right against discrimination for exercising rights</td>
</tr>
<tr>
<td>Enforcement</td>
<td>Antitrust-sized administrative fines (up to 4% global group revenue for serious violations)</td>
<td>Potentially high California AG enforcement ($7,500 per violation if intentional)</td>
</tr>
<tr>
<td>Class actions</td>
<td>No class actions for statutory damages</td>
<td>Data breach class action for statutory damage</td>
</tr>
</tbody>
</table>
Perform a data mapping exercise to document personal information that is maintained and processed by the business including key elements such as the information sources, formats, storage locations, usage, and recipients

Vendor review to determine whether any contract changes are required

Design and incorporate “Do Not Sell” links on relevant websites

Revise policies according to new disclosure requirements
- Online Privacy Policy supplement for California
- Employee Privacy Notices
- Breach Notification Procedures

Develop business procedures for receipt and handling of data requests including:
- Toll-free telephone number to submit requests
- Process for routing consumer requests (e.g. Helpdesk Ticketing System)
- Procedure to verify a requestor’s identity to submit requests for data access or deletion
- Providing request responses within 45 days

Educate the business, specifically key functions that support the data request and response workflow

The legislative details are available at https://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201720180AB375

Decisions pending on the CCPA amendments

Washington Privacy Act (SB-5376)
- Contained elements of the GDPR
  - Would have granted consumers the rights to know who was using their data and why, the right to delete certain data, and the right to restrict the sale of data
  - Enumerated steps to boost the security of collected consumer information
  - Bill passed the Senate but failed in the House following calls from privacy advocates because it was not considered strong enough (the bill still permits the use of facial recognition technology despite provisions to regulate its use)
WHAT’S NEXT? - continued

✓ CCPA copycat or similar bills failed in CT, HI, ND, NM, OR, TX, VA

✓ Mini-CCPA Bills pending in Illinois, New Jersey, Nevada

✓ IL HB 3358: Passed the House; Senate Passage Likely
   – Notice
   – Right to Know (but including approximate number of 3rd parties with whom personal
data is disclosed)
   – Opt-out of Sale

✓ NV SB 220: Passage Likely
   – Opt-out of Sale

✓ NJ: 2 bills, similar to IL, unlikely to be considered until Fall

✓ Other possibilities: Puerto Rico, NY, MA, Federal Data Privacy Legislation?

QUIZ ANSWERS PROVIDED AT CPE

✶ If an individual requests that you delete the information you have collected
   about them, you are required to do so

✶ A business email address is considered personal information

✶ You can telemarket from a blocked number, leave a message, and not
   include a callback phone number

✶ If someone registers for a course via a webform, you can send them
   marketing materials about your company
BACKGROUND

- Tax Cuts and Jobs Act of 2017 (“TCJA”) created IRC secs. 1400Z-1 and 1400Z-2
  - Designed to encourage investment in areas identified as disadvantaged, by census tracts, to be identified by the governors of the 50 states, District of Columbia, plus Puerto Rico and US Virgin Island, as well as certain other US territories
    - Designations were made by mid-2018 – over 8,700 opportunity zones designated
  - Proposed Regulations were issued by IRS on Oct. 19, 2018 (the “October Proposed Regulations”) which clarified certain issues, left other issues for future proposed regulations, and asked for comments from stakeholders on many issues
  - A second set of proposed regulations was issued on April 19, 2019 (the “April Proposed Regulations”), covering some of the “reserved” areas from the October Proposed Regulations, as well as amending some of the provisions in the October Proposed Regulations

Incentives for Investors

- A taxpayer who has realized a capital gain (ordinary income need not apply), can defer recognition of that capital gain by investing it into a Qualified Opportunity Fund (“QOF”) within 180 days of the sale creating the capital gain – the investor would get a zero basis in its ownership interest in the QOF
  - Subject to complying with requirements to invest in Opportunity Zone Property, investors can realize the following tax benefits:
    - If the QOF investment is held for 5 years, the investor increases its basis in the QOF by 10% of the deferred gain
    - If the QOF investment is held for another 2 years, or 7 years total, the investor increases its basis in the QOF by another 5%, for a total of 15%
    - In 2026, the taxpayer has to report the deferred gain, less the discounts identified above
    - If the investor holds the QOF investment for 10 years, can elect to step the basis up to FMV at the time of selling the investment, and practically eliminate all recognition of gain
Choice of Entity - Where Does the Choice Exist?

- Investor – if a capital gain is realized by a flow-through entity (partnership, “S” corporation, trust, estate, etc.), that entity can be the investor in the QOF, or its owners/beneficiaries can elect to make the deferred investment.

- QOF: as originally written, §1400Z-2(d)(1) defined a QOF as “any investment vehicle which is organized as a corporation or a partnership …”
  - Raised concern whether a limited liability company would qualify
  - This was clarified in Prop. Reg. §1.1400Z-2(d)-1(a)(1), which stated that “a taxpayer that is classified as a corporation or partnership for Federal tax purposes is eligible to be a QOF …”
    - This means that a limited liability company is eligible to be a QOF.

Choice of Entity - Where Does the Choice Exist?

- Qualified Opportunity Zone Business (“QOZB”): in most real estate investments that will require substantial improvement, a QOZB will be a necessity to make the overall investment work.
  - However, similar to the statutory language for QOBs, §1400Z-2(d)(2) included in the definition of QOZP both “qualified opportunity zone stock” and “qualified opportunity zone partnership interest.”
    - Qualified opportunity zone stock is defined as “any stock in a domestic corporation”
    - Qualified opportunity zone partnership interest is defined as “any capital or profits interest in a domestic partnership”
  - Again, the October Proposed Regulations came to the rescue
    - Prop. Reg. §1.1400Z-2(d)-1(c)(2) defines qualified opportunity zone stock as an investment in “an entity [that] is classified as a corporation for Federal tax purposes …”
    - Prop. Reg. §1.1400Z-2(d)-1(c)(3) defined a qualified opportunity zone partnership interest as an investment in “an entity [that] is classified as a partnership for Federal tax purposes …”
    - So, a limited liability company can also be used as a QOZB.
April Proposed Regulations – 10 Key Issues

- Guidance on investment in operating businesses; income sourcing rules are generous and sufficient to qualify a number of different types of businesses; and the working capital safe harbor has been extended to include the development of a trade or business

- Taxpayer is able to invest cash or other property in a QOF

- There is no substantial improvement test applicable to the purchase of unimproved land, but the land has to be used in the active conduct of a trade or business; a taxpayer is not allowed to rely on this rule if the land is unimproved or minimally improved and the QOF or QOZB purchased the land with an expectation, an intention, or a view not to improve the land more than an insubstantial amount within 30 months of purchase

- If a building has been vacant for five years, it is able to qualify as original use property, and does NOT need to be substantially improved

- Subject to an anti-abuse rule applicable to all leases, leased property is QOZBP as long as the lease is entered into after December 31, 2017, the terms of the lease are market-rate, and during substantially all of the QOF’s holding period for the property, substantially all of the use of the property is in a QOZ

- There are no prohibitions on related party leases, but these leases have to meet certain additional requirements
April Proposed Regulations – 10 Key Issues

- Delays that are attributable to waiting periods for government action for licenses, permits, zoning changes, etc. can extend the 31 month period for substantial improvement.

- A QOF partnership is generally allowed to make debt financed distributions, subject to 2 limitations: (a) if the investor has remaining deferred gain from a qualifying investment in a QOF, a distribution to that investor will trigger inclusion of that gain to the extent that the distribution exceeds the investor’s basis (which will include the investor’s share of QOF liabilities); and (b) if an investor receives a distribution from a QOF within the first 2 years of an investor’s contribution of cash and other property to the QOF, there are rules that could apply to re-characterize that original contribution as a non-qualifying investment (i.e., disguised sale).

April Proposed Regulations – 10 Key Issues

- Guidance is provided on how a QOF is able to reinvest proceeds resulting from a return of capital event or the sale or other disposition of QOZP - so long as the proceeds are reinvested in QOZP within 12 months, the proceeds are treated as qualified property; however, a QOF cannot sell assets without the recognition of gain, so the sale is a taxable event.

- An investor who has held its QOF interest for at least 10 years is able to elect to exclude capital gain from gross income if that gain is reported on a K-1 from a QOF partnership or “S” corporation and is attributable to the QOF’s sale of QOZP – goes a long way toward solving the exit issue that existed with respect to QOF partnerships and “S” corporations.
QOF Investments

- Under the April proposed regulations, the only sec. 1231 gain that is eligible for deferral through investment in a QOF is capital gain net income
  - Sec. 1231 applies to gains and losses on the sale or exchange of, among other things, non-inventory depreciable property and real property used in a trade or business and held for more than one year; if sec. 1231 gains for the taxable year exceed sec. 1231 losses for the taxable year, the net gains are treated as LTCG, subject to a recapture rule; if sec. 1231 losses exceed sec. 1231 gains, the net loss in treated as an ordinary loss
  - The April proposed regulations provide that with respect to gain that arises from sec. 1231 property, only capital gain net income can be deferred and the 180 day period for investment into a QOF begins on the last day of the taxable year

- A taxpayer can make a qualifying investment by transferring cash or other property to a QOF in exchange for an eligible interest, and this rule applies regardless of whether the transfer is a recognition or non-recognition event – i.e., property can be transferred to a QOF in a taxable transaction (non-sec. 351 transfer to a corporation) or a non-taxable transaction (sec. 351 or 721 transfers) in exchange for an eligible interest
  - If an eligible interest is received in exchange for other property, the amount of the taxpayer’s qualifying investment depends upon whether the transfer is in a carryover basis transaction or a taxable transaction – special rules apply when property is transferred to a QOF partnership
QOF Investments

- The April Proposed Regulations provide 2 rules with respect to sec. 707 disguised sales and investments in QOF partnerships:
  - If a contribution of property to a QOF partnership is characterized as something other than a contribution (i.e., a sale under the disguised sale rules), the transfer is not an eligible investment – requires an analysis at the time of an investment of deferred gain in a QOF partnership to make certain the contribution is not a disguised sale under sec. 707
  - If a taxpayer makes a contribution of property to a QOF partnership for which a deferral election is available, and the partnership makes a distribution to the partner, if these would be treated as a disguised sale if (a) any cash contributed is treated as non-cash and (b) in the case of debt financed distribution, the partner’s share of liabilities is zero, then the transfer to the partnership is not treated as an investment for which the deferral election could be made

QOF Investments

- If a taxpayer receives an interest in a QOF in exchange for services that the taxpayer provides to the QOF or a person in which the QOF holds any direct or indirect equity interest, the interest received is not a qualifying investment, and the OZ tax benefits do not apply – OZ tax benefits do not apply to a carried interest
- A taxpayer is allowed to acquire an eligible interest in a QOF from another person for either cash or other property – the amount of the qualifying investment is the amount of cash, or FMV of other property, as determined immediately before the exchange, that the taxpayer transferred in exchange for the eligible QOF interest
  - The amount of the qualifying investment is limited to the amount of gain that can be deferred under the sec. 1400Z-2(a)(1) election
  - Any gain realized on sec. 704(c) property is not eligible for deferral
QOF Investments

- Inclusion Events – are relevant only until the taxpayer has included in income all of the gain deferred thru the investment if a QOF – after 12/31/2026, the guidance regarding inclusion events will no longer be relevant
  
  - Generally, a taxpayer recognizes the gain it has deferred through investment in a QOF on the earlier of the date of an inclusion event or 12/31/2026; an event is an inclusion event only if and to the extent that a taxpayer transfers all or part of its qualifying investment and that transfer reduces the taxpayer’s equity interest in the QOF
    
    - Subject to additional rules and exceptions, a taxpayer’s receipt of a distribution from a QOF can be an inclusion event regardless of whether the taxpayer’s ownership interest in the QOF is reduced
  
  - The April Proposed Regulations contain a lengthy list of examples of inclusion events, and items that are not inclusion events

QOF Investments

- Inclusion events include:
  
  - Sale or exchange of all or a portion of a qualifying investment to the extent that there is a reduction in the taxpayer’s equity interest in the qualifying investment – transfers to disregarded entities do not count
  
  - The receipt of property, including cash, in a distribution, regardless of whether the taxpayer’s equity interest is reduced
  
  - Termination or liquidation of the QOF
  
  - Liquidation of QOF owner (QOF shareholder or partner), with special rules for secs. 336 and 337 distributions
  
  - Claim of worthlessness
  
  - Gifting a QOF qualifying investment, with special rules for transfers to grantor trusts
QOF Investments

- Any transaction that has the effect of reducing either (a) the amount of remaining deferred gain of one or more direct or indirect partners; or (b) the amount of gain that would be recognized by those partners on a fully taxable disposition of the qualifying investment that gave rise to the inclusion event to the extent that such amount would reduce that gain to an amount less than the remaining deferred gain.

- Non-inclusion events include:
  - Death of the investor
  - Contribution of a qualifying investment in a QOF to a grantor trust where the owner of the qualifying investment is the deemed owner of the trust under the grantor trust rules
    - A change in grantor trust status is an inclusion event unless it is a termination of grantor trust status by reason of the death of the owner
  - A sec. 721 contribution of a qualifying investment in a QOF partnership, so long as the transfer does not cause a termination of the QOF partnership or the direct or indirect owner of the QOF

- A sec. 708(b)(2)(A) merger or consolidation of a partnership that holds a qualifying investment, or of a partnership that holds an interest in such a partnership – but, the inclusion rules will apply to any part of the transaction that is otherwise treated as a sale or exchange.

- The total amount of gain to be included in gross income on the date of an inclusion event is limited to the remaining amount of deferred gain, reduced by any increase in basis made under sec. 1400Z-2(b)(2)(B)(iv) (the 5% step up in basis after 7 years).
  - Subject to this overall limitation, the determination of the amount of gain included in gross income when an inclusion event occurs is dependent upon the type of inclusion event.
  - The October Proposed Regulations provided that deemed contributions of cash to a QOF partnership that occur when the QOF incurs debt do not create a separate interest in the QOF to which OZ tax benefits attach – the October Proposed Regulations did not specifically address whether that means that a partner in a QOF is allowed to increase its basis in a qualifying investment by the amounts of is allocable share of partnership debt.
QOF Investments

- The April Proposed Regulations make it clear that this basis increase is allowed
- An investor with a mixed-fund investment in a QOF partnership has 2 separate bases, each of which is computed separately
- Under the April Proposed Regulations, a debt financed distribution is generally allowed
  - Two very important exceptions to the general rule that a debt-financed distribution from a QOF partnership does not affect the availability of OZ tax benefits:
    - Any distribution from a QOF partnership to a QOF investor with remaining deferred gain is an inclusion event to the extent that the distribution exceeds the partner’s tax basis – for a partner holding a mixed-funds investment, only the portion allocable to the qualifying investment is subject to this rule
    - Any distributions made within 2 years of a contribution of cash or other property have to be analyzed under the disguised sale rules

In the context of a tiered arrangement, where a QOF investor is itself a partnership, the five, seven and ten year basis step-ups are allocated to the owners of the QOF and to the owners of any partnerships that directly or indirectly own the QOF interests – the adjustments will track to the owners’ interests based on their share of the remaining deferred gain to which the adjustment relates.

An investor holding a qualifying interest in a QOF partnership or “S” corporation for at least 10 years will be able to elect to exclude from income its share of the gain from the sale of QOZP by the QOF.

Helps to solve the issue that existed with respect to an exit strategy out of a QOF partnership or “S” corporation.
QOF Investments

- In the context of a QOF partnership, the basis step-up election after a 10 year hold is available to step up to gross FMV, including liability relief
- There is no depreciation recapture on the sale or exchange of an interest in a QOF partnership in which the taxpayer has applied the FMV step-up election – i.e., sec. 751(a) does not apply

The QOF

- Form 8996 will be amended for the 2019 and subsequent years, to require additional information, likely including EINs of QOZB in which the QOF invests, and the amount of such investment
  - Increased reporting requirements so that data can be collected and disseminated regarding the impact of OZ investments
- The April Proposed Regulations changed the rules from the October Proposed Regulations, and give the QOF a choice of valuation method for purposes of the 90/10 test
  - For each tax year, the QOF can value its assets using the application financial statement valuation method, or the alternative valuation method based on the QOF’s cost – the QOF can change methods year to year, but must apply a single method consistently during each taxable year to all of its assets
The QOF

- The April proposed regulations provides that a QOF has 12 months within which to reinvest proceeds from a return of capital or sale or other disposition of QOZP – to the extent the proceeds are reinvested within 12 months, the proceeds are treated as QOZP for purposes of the 90/10 test

- Treasury and the IRS have concluded they do not have the authority to provide for nonrecognition of gain on a sale of an asset for a QOF
  - With respect to a QOF partnership, if the sale occurs after an investor has held its fund interest for at least 10 years, the investor is able to elect to exclude the gain allocable to that investor
  - In all other cases, a sale is a taxable event and there is no applicable nonrecognition provision

Qualified Opportunity Zone Business Property (QOZBP)

- An activity is a trade or business if it would be considered a trade or business under sec. 162

- The April Proposed Regulations tie the date of original use commencing with the placed in service date for purposes of depreciation and amortization
  - Original use of tangible property acquired by purchase commences on the date any person that places the property in service in the QOZ for purposes of depreciation or amortization
    - If property has been depreciated or amortized by any person, the property is not original use property and must be substantially improved to be QOZBP
  - Used tangible property acquired by purchase can qualify as “original use” property, but only if the property has not previously been used within that QOZ in a manner that would have allowed it to be depreciated or amortized by any taxpayer
QOZBP

- Vacant property can qualify as “original use” property if it has been vacant or unused for an uninterrupted period of at least 5 years
- The substantial improvement requirements does not apply to unimproved land, but land must be used in a trade or business in order to be considered QOZBP
  - A QOF is not allowed to rely on the “no substantial improvement” regulation if the land is unimproved or minimally improved and the QOF or QOZB purchase the land with an expectation, an intention, or a view not to improve the land more than an insubstantial amount within 30 months of the date of purchase
- The substantial improvement test is applied on an asset-by-asset basis, rather than on an aggregate basis – very controversial part of the April Proposed Regulations

QOZBP

- The April Proposed Regulations allow a QOF to lease property and have it qualify as QOZBP if certain requirements are met
- Leased property will be QOZBP if:
  - It is acquired under a lease entered into after Dec. 31, 2017
  - The terms of the least are market rate, as determined under sec. 482 at the time it is entered into
  - During substantially all pf the QOF’s holding period for the property, substantially all of its use was in a QOZ
- Leases of improved real property which is not expected to be placed in service within 30 months of entering into the lease will not qualify as QOZBP
QOZBP

- There is no general “original use” or “substantial improvement” test applicable to leased property
- No prohibition on related part leases, but there are additional rules:
  - The lessee cannot, at any time, make a prepayment of rent relating to a period of use that exceeds 12 months
  - If the original use of leased tangible PERSONAL property does not commence with the lessee, the lessee must become the owner of an equal amount (in value, as determined under the QOF’s valuation method) of tangible property that is QOZBP within the relevant testing period and there must be substantial overlap in the zones in which the lessee uses the leased TPP and the acquired TPP

Qualified Opportunity Zone Businesses (QOZBs)

- A QOZB is a trade or business that meets all of the following requirements:
  - Substantially all (70% under the October Proposed Regulation) of the tangible property owned or leased by the QOZB is QOZBP
  - At least 50% of the QOZB’s total gross income is derived from the active conduct of a trade or business in the QOZ
  - A substantial portion of the QOZB’s intangible property (40% under the April Proposed Regulations) is used in the active conduct of the business
  - Less than 5% of the average of the aggregate unadjusted bases of property is attributable to non-qualifying financial property
  - The business does not include the operation of a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack, gambling establishment, or a store if the principal business is the sale of alcohol for consumption off premises
QOZBs

- Substantially all of the property owned or leased by a QOZB must be QOZBP
  - In determining if this test is met, a QOZB will value its tangible property by following the same rules that apply to a QOF in valuing its assets under the 90/10 test
  - QOZB generally has a choice from year to year to either use the financial statement valuation method if it has an applicable financial statement or the alternative valuation method of cost
- The April Proposed Regulations provide broad, flexible income sourcing rules, for purposes of applying the 50% of gross income test, that will allow many different types of businesses in various industries to qualify
  - Three separate safe harbors that a business can rely upon and, if none of those apply, a general facts and circumstances test can be applied

QOZBs

- The first 2 safe harbors focus on the services performed for a trade or business by employees, independent contractors (and employees of independent contractors).
  - Under the first safe harbor, if at least 50% of all of those services based on hours, are performed in a QOZ, the test if met
  - Under the second safe harbor, if at least 50% of all of those services, based on the total amount paid by the entity for those services, are performed in a QOZ, the test is met
- Under the third safe harbor, it tangible property located in a QOZ as well as management or operational functions performed in a QOZ are each necessary for the generation of at least 50% of the gross income of the trade or business, the test is met
- If none of the three safe harbors are met, then a general facts and circumstances test is applied, but the regulations provide no guidance or examples
QOZBs

- If a business uses real property that is located in a QOZ but also uses real property that is located outside of a QOZ, the rule in sec. 1397C(f) applies such that all of the real property is deemed to be located within a QOZ for purposes of applying the QOZB tests if:
  - The amount of real property (based on square footage) that is located in a QOZ is substantial as compared to the amount outside of the QOZ (if the unadjusted cost of the real property inside a QOZ is greater than the unadjusted cost of real property outside of the QOZ); and
  - The real property located outside of the QOZ is contiguous to part or all of the real property located inside the QOZ

- The leasing of residential rental property qualifies as an active trade or business for purposes of a QOZB
  - However, merely entering into a triple net lease with respect to real property is not considered the active conduct of a trade or business — the taxpayer will need to conduct some other activity with respect to the leased property in order for there to be an active trade or business under the OZ rules

- The April Proposed Regulations amended the October Proposed Regulations with respect to the 31 month working capital safe harbor and provides that the safe harbor applies if amounts are designated in writing for the development of a trade or business in a QOZ, including, where appropriate, the acquisition, construction, and/or substantial improvement of tangible property in the OZ
QOZBs

- The 31 month working capital safe harbor can be extended if there is a delay caused by waiting for governmental action and the application for that action is complete before the end of the 31 month period
- Each contribution of cash to a QOF begins its own 31 month working capital safe harbor
  - The QOZB is able to apply the working capital safe harbor more than once, and/or have overlapping 31 month periods

Possible Legislative Changes

- As originally enacted, Sec. 1400Z-2 did not have any reporting requirements imposed – such reporting requirements were incorporated in early drafts but deleted from the final bill as passed
- Sens. Tim Scott (R-S.C.) and Cory Booker (D-N.J.), 2 of the original authors of what became Sec. 1400Z-2, are planning to introduce new legislation to require such reporting
  - Under the proposed legislation (scheduled to be introduced on May 6, 2019), the Treasury Secretary would be required to collect data on:
    - The number of opportunity funds created
    - Their holdings
Possible Legislative Changes (Cont’d)

- Their asset classes, including
  - Which type of real estate activity is funded;
  - Its square footage
  - Number of full time employees
- The economic ripple effects in the communities in which they invest, including
  - Job creation
  - Poverty reduction
  - New businesses
  - Other metrics as determined by the Secretary of the Treasury
- The data would have to be made public, but would remain anonymous
- The data would have to be reported annually to Congress, starting five years after enactment of the bill
- If passed, the preparation of tax returns for QOFs will be much more detailed and intrusive
Agenda

- Revenue recognition – update on new standard
- Leases – new standard implementation
- Other recent ASUs and a FASB project
Lessons learned adopting the new revenue standard

USF Accounting Circle Conference
May 17, 2019

Agenda

- Private entity adoption is here
- Public company adoption observations
- SEC areas of focus and frequent questions
- Operational challenges
- What are auditors thinking about?
- Lessons learned and next steps
Private entity adoption

- Private entities are required to adopt the new revenue standard for fiscal years beginning after December 15, 2018, irrespective of the method of adoption.
- FASB completed all anticipated amendments to clarify the new revenue standard in 2016.
- Five steps of the revenue recognition model:

  1. Identify the contract(s) with a customer
  2. Identify the separate performance obligations in the contract
  3. Determine the transaction price
  4. Allocate the transaction price to the separate performance obligations
  5. Recognize revenue when (or as) the entity satisfies a performance obligation

Transition approaches

The following chart summarizes the transition options available to entities based on a calendar fiscal year for U.S. non-public business entities:

<table>
<thead>
<tr>
<th>Transition approach</th>
<th>2018</th>
<th>2019</th>
<th>Date of cumulative effect adjustment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retrospective</td>
<td>Retestate for all contracts</td>
<td>Apply to all contracts</td>
<td>January 1, 2018</td>
</tr>
<tr>
<td>Retrospective Using One or More Practical Expedients</td>
<td>Retestate for all contracts except for contracts or estimates covered by the practical expedients elected by the entity</td>
<td>Apply to all contracts</td>
<td>January 1, 2018</td>
</tr>
<tr>
<td>Cumulative Effect at the Date of Adoption</td>
<td>No contracts restated; reported on the basis of legacy guidance</td>
<td>Apply to all new and open contracts or elect to apply to all contracts</td>
<td>January 1, 2019</td>
</tr>
</tbody>
</table>

The new lease standard is effective a year after the new revenue standard with early adoption permitted. When evaluating the timing and transition approach for both standards, companies need to consider the impact to resources and the linkages between revenue and leases for their transactions.
Change is challenging

- Detailed impact assessment
- Design processes and controls
- Develop and test systems and processes
- Revise Accounting Policies & Model Pro Forma Results
- Build IT Solutions
- Improve Systems, Processes, and Controls, as necessary
- Assess transition adjustment needs
- Design transition adjustment approach
- Implement transition adjustment
- Report and integrate

Implementation timeline

- Phase 1: Establishment of a project leader and a project plan and timeline
- Phase 2: Assess and define impacts of standards on each financial stream
- Phase 3: Select IT and manual solutions, including controls, to ensure completeness and accuracy of data required
- Phase 4: Design of internal controls over the adoption process, as well as re-design of current processes and controls
- Phase 5: External audit walkthrough over new and revised processes
- Phase 6: Finalization of adoption documentation and accounting entries to record the transition adjustment in financial statements
AICPA revenue recognition task forces

Continuing to deliberate and publish issue papers

AICPA Financial Reporting Executive Committee (FinREC)

AICPA Revenue Recognition Working Group

AICPA 16 Industry Task Forces

Aerospace and Defense
Airlines
Asset Management
Broker-Dealers

Construction Contractors
Depository Institutions
Gaming
Health Care

Hospitality
Insurance
Not-for-Profit
Oil and Gas

Power and Utility
Software
Telecommunication
Timeshare

Developing a new Revenue Recognition Accounting Guide with illustrative examples

http://www.aicpa.org/InterestAreas/FRC/AccountingFinancialReporting/RevenueRecognition/Pages/default.aspx

Public company adoption observations
Public company adoptions

### Why adopt using the cumulative effect method?

<table>
<thead>
<tr>
<th>Adapting using cumulative effect method</th>
<th>91%</th>
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</thead>
<tbody>
<tr>
<td>Cumulative effect preferred for IPO ready companies as no need to revise earlier historical periods</td>
<td></td>
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<tr>
<td>Relative cost</td>
<td></td>
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<tr>
<td>Data for the full retrospective method was not easily available</td>
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<tr>
<td>Insufficient time to accommodate a full retrospective adoption</td>
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<tr>
<td>Communicate the impact to users of the financial statements</td>
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<tr>
<td>Item 4 disclosures for changes in controls</td>
<td></td>
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<tr>
<td>Changes for transition and ongoing processes and controls</td>
<td></td>
</tr>
</tbody>
</table>

#### Considerations when adopting the cumulative effect method

- Data for the full retrospective method was not easily available
- Cumulative effect preferred for IPO ready companies as no need to revise earlier historical periods
- Relative cost
- Communicate the impact to users of the financial statements
- Item 4 disclosures for changes in controls
- Changes for transition and ongoing processes and controls
SEC consultation themes

The SEC has received a number of prefiling inquiries:

- Principal versus agent
- Identifying performance obligations
- Payments to customers
- Identifying the contract and contract combination
- Variable consideration and allocation
- Royalty exception
Operational challenges

Entities have encountered a number of operational challenges

- IT automation
- Estimation
- Disclosures
- Allocation of contract costs
- Stakeholder interactions
- Adoption approach
Lessons learned and next steps

For all companies
— Continuously review your disclosures and assess whether they are sufficient for investors and users of the financial statements
— Consider additional pro forma information in MD&A and provide clear business KPIs to manage investor expectations
— Connect with peers in your industry
— Maintain continuous dialogue with oversight board and auditors
— Embed ASC 606 revenue into your quote to cash value chain and look for automation opportunities where possible
— Adjust your diligence approach and target evaluation during M&A

For public companies
— Consult with the SEC or your audit firm as needed
— Monitor and evaluate ongoing SEC interpretations and guidance
  - Presentation and disclosure requirements
  - Updates to the Financial Reporting Manual (FRM)
  - Emerging Growth Company (EGC) considerations
  - Reverse mergers
  - Supplemental MD&A disclosures
Revenue resources

Visit KPMG’s webpage on revenue on KPMG’s Financial Reporting View https://frv.kpmg.us/all-topics/revenue.html

The following industry publications are also available:
- Aerospace and Defense
- Asset Managers
- Chemical Manufacturers
- Consumer Products
- Engineering and Construction
- Franchisors
- Freight and Logistics
- Healthcare Providers
- Life Sciences
- Manufacturers
- Power and Utilities Companies
- Handbook: Revenue for Software and SaaS
- Software and SaaS
- Telecoms
- Real estate
- Retailers

ASC 842: the new leases standard

USF Accounting Circle Conference
May 17, 2019
Where are we now?

**Public entities**: effective for annual and interim periods in fiscal years beginning after December 15, 2018

**All other entities**: effective for annual periods in fiscal years beginning after December 15, 2019, and interim periods in fiscal years beginning after December 15, 2020

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**Overview and transition**

**Overview**:
- Lessees will recognize most leases on-balance sheet—increasing reported assets and liabilities, sometimes significantly
- Lessor accounting remains substantially similar, but there are some important changes
- Implementation of the new standard could have broad organizational impacts beyond general accounting and financial reporting

**Effective Date**:
- Private entities are required to adopt the new lease standard on January 1, 2020
- Early adoption is permitted

**Effective date method**
- Initial application is first day in the period of adoption
- Comparative periods unchanged, transitional adjustment recorded to equity on [the date of adoption]
- Repeat prior year lease disclosures (under Topic 840) in year of adoption

**Comparative method**
- Initial application is the first day of the earliest comparative period presented
- Restate all comparative periods presented, with a transitional adjustment recorded to equity on [the first day of the first comparative period]
- Include all required disclosures under Topic 842 for comparative periods presented

**Modified retrospective transition (same for lessees and lessors)**:
- No revisions to the accounting for leases that expired prior to date of initial application
- Permitted to elect a package of transition practical expedients, grandfather accounting for land easements, and/or use hindsight for certain judgments/estimates
Key implementation challenges

1. The ‘date of initial application’ for many companies is now in the past
2. Identifying the complete population of leases
3. Abstracting key terms to ensure accurate transition accounting
4. Enhanced lessee and lessor disclosure requirements
5. New reassessment and modification provisions will require new processes and controls

What are other common challenges?

- Lease team – renewal options, short-term exemption, hindsight, termination clauses
- Discount rate
- Variable lease payments – allocation to lease and non-lease components
- Including ROU asset in long-lived asset impairment analysis

Beginning work now is key

Obtaining the technical knowledge is key
Staying informed

— Financial Reporting View:
  https://frv.kpmg.us/

— KPMG Executive Education:
  www.execed.kpmg.com

— KPMG Leases Handbook:

— KPMG Executive View Publication on SAB 74 Disclosures:

— KPMG Defining Issues on decisions made at the November 29, 2017 FASB meeting:

— KPMG’s Accounting Change Survey – Revenue and Leasing:

Don’t delay
— Sufficient time needs to be allocated to allow for:
  - identifying the complete population of leases,
  - collecting and abstracting all relevant data for each lease to enable proper accounting, and
  - external auditor procedures over implementation activities and audit of the transition accounting and related internal controls.

Completeness of lease population is critical initial step
— Even if package of transition practical expedients is elected, companies are required to evaluate the completeness of the population of existing leases. The practical expedients do not forgive errors in applying current GAAP.
— May not have been a focus under previous lease standard.

Assessment and implementation is harder than you think
— Estimate is that each lease will average 3 hours to account for under the new lease accounting standard.
— Various judgments and estimates required for transition and subsequent accounting that may require technical accounting resources.

Key messages and reminders

Topic 842 introduces new estimates and judgments for both lessors and lessees
Key messages and reminders, contd.

Cross-functional involvement is required
— The new standard depends on a detailed understanding of the company’s business and contracts that cannot be outsourced.
— Senior leadership buy-in is key to ensure cross-functional collaboration is prioritized.

Potential changes required to processes, systems, and controls
— Critical part of overall implementation will be ensuring appropriate processes and controls are in place over the transition and ongoing reporting.
  - Identification of lease arrangements
  - Capability to account for right of use assets and lease liabilities under new lease standard
  - Capability for ongoing monitoring of lease reassessments and modifications

Internal controls need to be in place over the (1) transition and (2) ongoing reporting under Topic 842

ASU 2018-15
Customer’s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement

ASC Topic 350
FASB update

The FASB issued an ASU based on a consensus of the FASB's Emerging Issues Task Force (EITF) that requires implementation costs incurred by customers in cloud computing arrangements (CCAs) to be deferred and recognized over the term of the arrangement, if those costs would be capitalized by the customer in a software licensing arrangement under the internal-use software guidance in ASC 350-40.

The new deferred implementation cost assets would affect companies' financial ratios and deferred tax accounting.

Scope of ASU 2018-15

What is a cloud computing arrangement (CCA)?
- A hosting arrangement* that does not transfer a license to the hosted software to the customer

This ASU does NOT change the accounting for software licensing arrangements (which includes hosting arrangements that do transfer a license to the hosted software to the customer).

* An arrangement where the customer accesses the vendor's software over the internet or a dedicated line. The software is hosted on the vendor's (or a third-party on behalf of the vendor) infrastructure.
Key changes

<table>
<thead>
<tr>
<th>Accounting for CCAs</th>
<th>Current guidance</th>
<th>ASU 2018-15</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>The CCA is accounted for as a service arrangement; no software license is conveyed to the customer.</td>
<td>No change.</td>
</tr>
</tbody>
</table>

| Implementation costs | Most implementation costs are expensed as the related implementation activities are performed. | Implementation costs should be deferred if those same costs would be capitalized by the customer if incurred in a software licensing arrangement. |

The ASU requires companies to defer potentially significant, specified implementation costs that are often expensed as incurred under current GAAP.

Costs incurred to implement a CCA

- Costs incurred to implement a CCA will be (1) deferred or (2) expensed as incurred in accordance with the guidance for the capitalization or expensing of such costs under existing internal-use software guidance.
- Not all implementation costs will be deferred under the ASU.
- Companies will need to allocate costs between deferrable and non-deferrable implementation activities on a relative fair value basis.
- Implementation costs are not defined in the new ASU.
- The EITF decided that implementation costs did not need to be defined since internal use software guidance already provided sufficient guidance.
Effective Date and Transition

<table>
<thead>
<tr>
<th>Public companies – Annual and interim reporting periods for fiscal years beginning after</th>
<th>Effective date</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>December 15, 2019</td>
</tr>
</tbody>
</table>

| All other companies – Annual reporting periods for fiscal years beginning after       | December 15, 2020 |
| All other companies – Interim reporting periods for fiscal years beginning after     | December 15, 2021 |
| Early adoption allowed, including interim periods?                                    | Yes. |

Transition

<table>
<thead>
<tr>
<th>Transition</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prospective transition</td>
<td>All CCA implementation costs for activities performed on or after the effective date, including costs for (1) new CCA© entered into on or after the effective date and (2) existing CCAs entered into before the effective date; or</td>
</tr>
<tr>
<td>Retrospective transition</td>
<td>Apply the ASU as if it had always been US GAAP (including in comparative periods).</td>
</tr>
</tbody>
</table>

ASU 2018-13

Disclosure Review – Fair Value Measurement Overview

- Modifies the disclosure requirements in ASC Topic 820, Fair Value Measurement
- Applies to all entities that are required to disclose recurring or nonrecurring fair value measurements.
- Effective for all entities for all reporting periods (annual and interim) beginning after December 15, 2019
- Early adoption is allowed

Proposed ASU

Extending the Private Company Alternatives on Goodwill and Certain Identifiable Intangible Assets to Not-for-Profit Entities (Topics 350, 805, 958)
Proposed ASU

**Objective**

- Extend the private company alternatives from ASC 350 (ASU 2014-02) and ASC 805 (update 2014-18) to not-for-profit entities (NFPs)
- Reduce cost and complexity related to the accounting for goodwill and certain intangible assets

**Applicability**

- All not-for-profit entities, including those that are conduit bond obligors

**Relevant Dates**

- December 20, 2018 – FASB issued proposed ASU
- February 18, 2019 – Comments due on proposed ASU

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Proposed ASU

**Current US GAAP**

- Test goodwill for impairment annually at the reporting unit level
- NFP acquirer recognizes certain identifiable such as certain customer-related intangible assets and noncompeting agreements separately from goodwill in an acquisition
- Equity method investments (inclusive of goodwill) are evaluated for impairment in accordance with ASC 323-10-35-32

**Proposed ASU – Key Facts**

- Amortize goodwill, including equity method goodwill, on a straight-line basis over 10 years (unless a shorter useful life is more appropriate)
- Test goodwill for impairment only when a triggering event occurs and would be permitted to test at either the entity level or the reporting unit level
- No change to equity method evaluation for impairment
- An NFP would be permitted to elect to not separately recognize certain intangible assets (e.g. certain customer-related intangible assets and noncompeting agreements)
- When an NFP elects the alternative in ASC 805, it would be required to also elect the alternative in ASC 350, however, when an NFP elects the alternative in ASC 350, it would not be required to elect the alternative in ASC 805
Proposed ASU

Key impact

- Reduce the likelihood of impairments;
- Simplify the impairment test when it is required; and
- Result in recognition of fewer intangible assets in future business combinations

Proposed effective date and transition

- Effective date will be determined after the board considers stakeholders’ feedback.
- An NFP electing the accounting alternative in Topic 350 would apply it prospectively for all existing goodwill and for all new goodwill generated in acquisitions by the NFP after the effective date.
- An NFP electing the accounting alternative in Topic 805 would apply it upon the occurrence of the first transaction within the scope of the alternative.

Thank you
The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

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