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# TODAY'S CPA

Texas Society of Certified Public Accountants

## Cyberattacks and Ransomware Demands on Municipal Governments and SMEs

CONSOLIDATED APPROPRIATIONS ACT, 2021

LOAN FORGIVENESS AND THE 2021 TEXAS FRANCHISE TAX

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MANAGING EDITOR
DeLynn Deakins
ddeakins@tx.cpa
972-687-8550
800-428-0272, ext. 8550

TECHNICAL EDITOR
Brinn Serbanic, CPA, CFP®
technicaleditor@tx.cpa

COLUMN EDITOR
Don Carpenter, MSAcc/CPA

WEB EDITOR
Wayne Hardin
whardin@tx.cpa

CONTRIBUTORS
Melinda Bentley; Kenneth Besserman, JD; Sarah Brown; Roxanne LaDu; Holly McCauley; Craig Nauta; Kari Owen; Rori Shaw

DIRECTOR, MARKETING AND COMMUNICATIONS
Melinda Bentley, CAE

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

Editorial Board
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# A CONSTANT IN A TIME OF CHANGE

By TXCPA Chairman Jerry Spence, CPA-Corpus Christi

## Share Your Thoughts

I'd love to hear your feedback and answer your questions. Drop me a note at chairman@tx.cpa.

Welcome to your March/April issue of *Today's CPA*. What a difference a year makes. Last year at this time, many of us were grappling with going fully remote with our work and our teams, some while trying to continue to meet an April 15 tax deadline that would eventually be pushed out. I imagine if you look at how you work today and what your priorities are now, you are still seeing and feeling the impact from that sudden shift and the months of rapid change that followed.

One thing that has remained constant in this time of change is the support of TXCPA. When your organization's vision is to empower members to lead and succeed, you shift and adapt to what members need at any given time. I hope you have had the opportunity to take advantage of the unique and timely learning opportunities, our various member communications and the power of our peer network on TXCPA Exchange over the past year. TXCPA and our local chapters have been hard at work to help us stay connected when we cannot be together in person, while keeping us updated and educated on all of the changes that have impacted our profession over the past year.

In this issue, you'll find more of those valuable updates. From our cover story on cyberattacks and ransomware demands on municipal governments and SMEs to the self-study CPE article on audit-related enforcement actions and everything in between, *Today's CPA* is designed to keep you informed and engaged through your TXCPA membership.

In an era of rapid change and a profession trained to help the public navigate those changes, thank you for trusting TXCPA as a resource. With the continued support and dedication of our members, we are truly better together.

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# HOW PPP LOAN FORGIVENESS WILL AFFECT the 2021 Texas Franchise Tax

**By Remington T. O'Dell, CPA**

The Payroll Protection Program (PPP) was created by the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) in March of 2020. The program closed on August 8, 2020 after providing billions in potentially forgivable loans for businesses and non-profits to keep workers on the payroll.

Much time and effort has been paid to how the forgiveness of PPP funds will affect federal tax planning; however, not as much attention has been paid regarding the state tax considerations. Only recently have states begun to issue any guidance on whether the forgivable PPP loan proceeds are taxable at the state level.

Depending on the guidance issued, many taxpayers that have never filed a state tax return before may find themselves forced to do so for 2020, including taxpayers subject to the Texas franchise tax.

## Federal Tax Treatment

Initially, PPP funds were touted to be excluded from taxability. In accordance with CARES Section 1106(I):

> **"For purposes of the Internal Revenue Code of 1986, any amount which (but for this subsection) would be includible in gross income of the eligible recipient by reason of forgiveness … shall be excluded from gross income."**

While many tax professionals took this language as verification of Congress's intent to exclude the forgiven PPP loan proceeds from being taxed, that was not the interpretation of the IRS. In Rev. Rul. 2020-27, the IRS states that a taxpayer may not deduct eligible business expenses that were paid with PPP loan proceeds, if the taxpayer reasonably expects to receive forgiveness of its PPP loan.

With the passage of the 2021 Omnibus Appropriations Bill by Congress on December 21, 2020, clarification on the tax treatment of PPP forgiveness has finally been provided. The bill makes clear that PPP forgiveness:

- Is not taxable,
- Is excluded from income, and
- Will not reduce any deductions attributable to those funds.

Deductions are allowable for expenses paid with the proceeds of a forgiven PPP loan. In accordance with the provisions of the bill, this change is retroactive to date of enactment of the CARES Act.

## Texas Franchise Tax Treatment

Although the 2021 Omnibus Bill brings good news on the federal level, things are quite different on the state level. In accordance with a general information letter (GIL202012080995540) issued by the Tax Policy Division of the Texas Comptroller of Public Accounts on December 11, 2020:

> **"If a Paycheck Protection Program (PPP) loan is forgiven, the debt forgiveness will be considered income for franchise tax reporting unless it qualifies for an exception from being recognized as income under the 2007 Internal Revenue Code."**

While general information letters are not binding on the Comptroller,

it appears that this analysis of the Texas Franchise Tax Code by the Comptroller's office is correct and can only be changed by legislative action.

The Texas franchise tax has fixed conformity to the Internal Revenue Code (IRC) as of Jan. 1, 2007. As a result, cancellation of debt (COD) income is governed by IRC 108 as it existed in 2007. This means that subsequent changes to the IRC by CARES Section 1106(i) and the 2021 Omnibus Bill are nonbinding upon the state.

This interpretation of PPP proceeds as COD income will require taxpayers, for Texas franchise tax purposes, to adjust the gross revenue on 2020 tax return using the 2007 IRC rules and use that amount for franchise tax reporting. This is similar to the depreciation adjustments necessary for Cost of Goods Sold (COGS) or Indirect Costs.

## Apportionment of COD Income

Another unexpected result for taxpayers is how COD income interacts with the income apportionment rules under the Texas franchise tax code. In accordance with Rule § 3.591(e)(5):

> **"Debt forgiveness. If a creditor releases any part of a debt, then the amount that the creditor forgives is a gross receipt that is apportioned to the legal domicile of the creditor."**

By allocating COD income to the creditor's legal domicile, Rule § 3.591(e)(5) has the unfortunate result of potentially penalizing Texans for using local Texas banks.

Additionally, some local banks were hesitant to offer PPP loans due to the administrative burden they bore and instead turned potential borrowers towards online loan facilitators. Almost $5.7 billion in PPP loans were handled by Lendio alone, which is not a direct lender but facilitates PPP loans as an agent through a network of approved lenders that includes banks, credit unions and non-bank SBA lenders.

Borrowers that went through such online loan facilitators may not be aware of the legal domicile of their creditor, so it is vital that borrowers research such information for state franchise tax planning purposes.

## What to Expect

The inclusion of the COD income by the PPP loan borrower could certainly force many taxpayers that have never filed more than a No Tax Due Report over the filing threshold for the first time. This unexpected tax burden could not come at a more unwelcome time as many Texas businesses are barely holding on by a thread during the COVID pandemic.

As of press time, bills have been filed in the 87th Texas legislative session to address this situation. However, until a bill is signed, it is always a good idea "to plan for the worst and hope for the best."

**ABOUT THE AUTHOR:** *Remington T. O'Dell, CPA, is a tax manager at Boucher, Morgan and Young, a P.C. in Stephenville, TX.*

**EDITOR'S NOTE:** For more information on this topic, please also see the article "PPP Loans and the Texas Franchise Tax" by Christina Mondrik, CPA-Austin, available on TXCPA's website at www.tx.cpa/resources/news/articles/ppp-loans-and-the-texas-franchise-tax.

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CAPITOL INTEREST

# OFF AND RUNNING IN THE 87TH TEXAS LEGISLATIVE SESSION

**By Kenneth Besserman, JD, TXCPA Director of Government Relations and Special Counsel**

The 87th Texas legislative session was gaveled in on January 12, 2021. Predictably, and in the midst of a pandemic and surging COVID-19 cases in Texas, opening day of the session began and ended very quickly. Both houses of the legislature spent very little time in the chambers – dispensing very quickly with speeches, recognitions, ceremonies, and the House's and Senate's required business. Among many things that were different on opening day compared to past sessions, the ceremonies were short, visitors and guests were limited, masks were ever present and for the second consecutive session, there is a new speaker of the House.

The week before opening day, the nation witnessed protests, riots and the breaching of the U.S. Capitol by those seeking to disrupt the certification of the Electoral College. Before and after January 6, tensions were high in Washington, D.C. and around the country, and state capitols were on high alert. Fortunately, there were no incidents in Austin leading up to or on opening day of the session.

In the Senate, Lt. Governor Dan Patrick started his fourth session in charge with Republicans maintaining an 18-13 majority, one less than last session. There are four freshmen senators – Sarah Eckhardt (D-Austin), Cesar Blanco (D-El Paso), Roland Gutierrez (D-San Antonio) and Drew Springer (R-Muenster).

While the party makeup changed very little from last session, after vigorous and heated debate the Senate adopted new rules, which now only require 18 votes to bring a bill up for consideration. This will make it easier for the party in power to shepherd through and pass much of their agenda.

In the House, Rep. Dade Phelan (R-Beaumont) was elected speaker of the House in an almost unanimous vote. Shortly after the election on November 3, where the Republicans maintained their majority in the same 83-67 split as in the 86th session, Phelan emerged as the consensus choice for speaker after the announced candidates pledged their support for him.

With the speaker elected, the House turned to debating House rules relating to how committees will function and how floor debate will occur. The House voted to allow members to cast their floor votes from their floor desks or from secure locations close to or attached to the House floor.

In addition, the House voted to allow virtual testimony in committees only for invited testimony. The public will still have access to the Capitol and committee rooms if they wish to testify or register support for or against legislation in committee. The full House and Senate rules can be found on the TXCPA Session page once the rules have been published.

The legislature then adjourned until January 26. It is quite common for the House and Senate to adjourn for many days at a time early on in the session. The House and Senate cannot pass legislation before the 60-day mark of session unless the governor sets the matter as an emergency item.

While House and Senate floor debate on legislation is limited in the first 60 days, committees may meet and discuss legislation. Patrick named Senate committee chairmen and members prior to the session. That information can also be found on the TXCPA Session Page. While no bills other than SB 1, the state budget, have yet been referred to any committees, the Senate Finance Committee will begin hearing testimony on the state budget.

Week two of the session also began and ended promptly. Both the Senate and House were in session for a couple of days taking care of administrative matters. On Wednesday, January 28, both the Senate and House adjourned until February 9. While multi-day adjournments are common at the beginning of all sessions, this extended adjournment is a little bit longer than usual. As we know, COVID-19 has clouded legislative operations.

In the House, Phelan asked that members submit their committee assignment requests by January 27. After committees are assigned, the House can begin referring bills to committee and they can begin hearing bills. While no floor action, except emergency measures, can be debated on the House or Senate floor in the first 60 days of session, committees can still hear testimony. Phelan announced his new committee chairmanships and committee appointments on February 4. Some of the

most significant appointments to committee chairs include Appropriations – Greg Bonnen (R-Friendswood), Calendars – Dustin Burrows (R-Lubbock), Redistricting – Todd Hunter (R-Corpus Christi), Public Education – Harold Dutton (D-Houston), Licensing & Administrative Procedures – Senfronia Thompson (D-Houston), and Ways & Means – Morgan Meyer (R-Dallas).

Of the 34 standing committees, 21 will be chaired by Republicans, 13 by Democrats and Rep. Joe Moody (D-El Paso) will serve another term as speaker pro tem. Five committee chairs and 14 vice-chairs are women, while 14 chairs and 21 vice-chairs are Black, Hispanic or Asian American.

In the Senate, the Redistricting Committee began holding public hearings on new state and Congressional maps. While initial Census data may be delivered to the states in late April, final Census data may not arrive at the state level until mid-June or July, making it impossible for the House or Senate to pass maps during the regular session. In all likelihood, the governor will call members back for a special session this summer to draw legislative maps. Don't make your vacation plans just yet!

Governor Greg Abbott gave his State of the State address at 7 p.m. on February 1, laying out his priorities for the session. Those items were expanding broadband internet access, punishing local governments that "defund the police" as he defines it, changing the bail system, ensuring "election integrity" and providing civil liability protections for businesses that were open during the pandemic.

By designating these items as emergency items and presenting that declaration to the legislature, both the House and Senate may debate those items during the first 60 days of the session.

In addition to the emergency items, Abbott laid out a few more of his legislative priorities, which include making Texas a "Second Amendment sanctuary state," legislation to strengthen civics education in Texas public schools and further restrictions on abortion. It is still too early to know whether these issues will pass or not, but they provide Abbott with a platform on which to run again for governor in 2022 or possibly be a candidate for president in 2024.

One of the biggest issues facing the legislature and the governor is the emergency powers that a governor has during times of natural disasters and in times of declared emergencies. This issue has come to the forefront during the pandemic. While very well intentioned, legislators and the general public, from both sides of the political spectrum, have questioned whether the current law regarding emergency declaration and the attendant powers of the governor need to be reviewed, updated, expanded or left alone.

Proposals have been filed and discussed to give the governor more express authority to take certain actions, and for legislative review and approval of gubernatorial actions. This will be one of the hot topics of the session and the debate will be interesting to watch.

At the start of the session, Comptroller Glenn Hegar released the Biennial Revenue Estimate (BRE), which details the amount of revenue that will be available to the legislature for the 2022-2023 state budget. The Comptroller's BRE detailed that the state will have about $113 billion available for general purpose spending, a very slight decrease from the amount available for the current budget. In addition, the Comptroller is only predicting a $1 billion shortfall in the current budget compared to what was predicted last fall.

## TXCPA Advocacy Day

We held our 2021 Virtual Advocacy Day on Tuesday, January 26. Our program included Ross Ramsey (***Texas Tribune***), Joe Crosby (Multistate) and the TXCPA contract lobbyists discussing a myriad of issues ranging from the state budget, taxes, accounting issues, session operations, redistricting and the TXCPA legislative agenda.

Following our speakers' program, TXCPA hosted over 60 meetings with Texas legislators. We spoke with our representatives, senators and their staff about their legislative priorities and how session will operate. We also had an opportunity to speak about the TXCPA legislative agenda, the importance of the accounting profession to the state and the economy, and much more.

**At the time of writing this article in early February 2021, the legislature will have been in session for about three weeks. Additional weekly updates can be found on the TXCPA Session Page on the website.**

We will continue with many more meetings in the coming weeks. We appreciate all of the TXCPA members who were able to join these virtual legislative visits.

As session speeds up and as more issues important to TXCPA and the accounting profession arise, please continue to look for our weekly ***Last Week in the Legislature*** articles on the TXCPA Session page.

**About the Author:** Kenneth Besserman, JD, is TXCPA's Director of Government Relations and Special Counsel. Contact him at kbesserman@tx.cpa.

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# TXCPA'S NEW CFO: **EDIE COGDELL, CPA, CGMA**

Last December, Edie Cogdell, CPA, CGMA, joined TXCPA's staff as the new CFO. She is taking over the role from Steve Phillips, CPA, who retired from TXCPA on January 6. She came to TXCPA from the University of the Incarnate Word (UIW) in San Antonio, where she worked as the associate vice president for business and finance and comptroller.

Cogdell obtained a BBA with a double major in Accounting and Finance from Baylor University and an MBA from UIW. She has been an active member of TXCPA and TXCPA San Antonio for a number of years, having served on TXCPA's Executive Board and as chapter president of TXCPA San Antonio. We're excited to introduce you to her in this issue of *Today's CPA*.

**You recently made the move to the Dallas area from San Antonio. Where were you born and where did you grow up?**

I was born in Evanston, Illinois and grew up in Evanston and Northbrook, Illinois. We moved to Boerne, Texas right before I started high school because my dad started a new job with USAA in San Antonio. I lived there until I started college. That's actually where I met my husband – I worked for his parents during high school. We just bought a home in Greenville and moved in right after Christmas. We're excited about starting our new adventure here. I love Texas and I'm looking forward to serving our Texas CPA members.

**Tell us about your previous jobs and your career.**

I worked in public accounting firms for 10 years, specializing in non-profit and governmental audits. After starting with Arthur Andersen in Houston, I worked for Doshier, Pickens & Francis in Amarillo, as well as Rylander, Clay & Opitz and Whitley Penn in Fort Worth. I finished my public accounting career as an audit manager at KPMG in San Antonio. My husband previously worked for the State of Texas, so we relocated several times before he retired.

Most recently, I worked for UIW for the past 21 years. I managed the accounting operations for six nonprofit entities with a combined operating budget of $250 million and served as the finance liaison for three affiliated international universities in Mexico and Germany. I'm passionate about education and glad to be working for another great nonprofit organization with a significant educational component.

**What influenced you to pursue an accounting career?**

When I started at Baylor, I was majoring in finance and planned to go to law school. I really liked my first accounting class and decided to add that as a major. As I progressed in the accounting program, I knew that was the career path for me. My favorite accounting professor at Baylor, Dr. Parsons, was also a great mentor and gave me wonderful advice over the years. I love working with numbers and people, and have never looked back. I've had a rewarding career.

**Who is or was your role model and why?**

The former CFO at UIW was one of my biggest role models. In the 20 years I worked for him before he retired, he taught me many life lessons in business. His work ethic, honesty and integrity drove his actions on a daily basis. He was loyal and supportive, and he was always willing to roll up his sleeves to get the job done. He always challenged me to do my best.

**Why has volunteering or committee service in TXCPA been so important to you?**

It's important to give back to the profession that has given so much to me during my career. It takes the time and talents of a diverse group of staff and volunteers to operate a complex organization like TXCPA. My service as a volunteer also helped me build my leadership skills and network with my peers throughout the state. My involvement has helped me hit the ground running at TXCPA.

**Tell us about your family.**

My wonderful husband Bill and I have been married for 31 years. I'm so happy he was willing to relocate for me to accept this exciting new opportunity as the incoming CFO at TXCPA. This move puts us much closer to his mom and their family farm in Mexia, so it will be nice for him to spend more time there.

We have two daughters, Chelsea (26) and Mary (23). Chelsea just accepted a new position at Methodist Hospital in San Antonio as a charge nurse in the COVID unit. She got her bachelor's degree in nursing from UIW and is currently in an online master's program at UT Arlington to become a nurse practitioner. Mary has a bachelor's degree in biology and a master's degree in healthcare administration from UIW. She is a practice coordinator for Team Health at St. David's in the south Austin medical center and lives in Dripping Springs. My parents and younger sister Jessica and her family still live in Boerne.

## TXCPA Members Receive 2021 B&I Award

Two TXCPA members – Mark Goldman, CPA-San Antonio, and Stephen King, CPA-Houston – were recently recognized with the 2021 B&I award! The award honors CPAs who have spent their careers in B&I and have made significant contributions through their influence and impact on others in the accounting profession.

**Mark Goldman** is the founder of MGR Accounting Recruiters and Where Accountants Go, a career website for accountants, and he is the author of the book "49 Tips for a Successful Accounting Career." He is an active member in TXCPA and TXCPA San Antonio. He has also been involved in other accounting-related organizations.

**Stephen King** is the founder and CEO of GrowthForce, one of the nation's largest cloud-based bookkeeping, accounting and controller services. He is an energetic and motivational business leader, entrepreneur and speaker with a passion for helping businesses grow and nonprofits prosper. He has actively served with TXCPA and TXCPA Houston.

TXCPA congratulates Mark Goldman and Stephen King on being named as 2021 B&I award recipients!

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## Maximize Value with Group Billing Program

Do you have several TXCPA members who work in your organization? Take advantage of our convenient Group Billing Program! Group billing allows renewal of all memberships within your organization at one time with a single dues invoice. Plus, group billing participants are eligible for 25% savings on the popular TXCPA Passport when purchased with renewals.

If you'd like to participate in group billing and make your renewal process easier, please contact Stephanie King at sking@tx.cpa or 800-428-0272, ext. 8533.

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## TXCPA Knowledge Hub

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## Advocacy Day and TXCPA Midyear Board of Directors and Members Meeting

TXCPA's Advocacy Day and Midyear Board and Members Meeting was held virtually this year on Jan. 26-27, with more than 60 virtual legislative visits held during the afternoons of Jan. 26, 27 and 28. Please see the Capitol Interest article in this *Today's CPA* issue for more information about the virtual legislative visits.

Find a video recap in our meeting reports online here https://www.tx.cpa/about/leadership/meeting-reports.

### Strategic Plan Update

Strategic Planning Committee Chair Ben Simiskey, CPA-Houston, CFP®, PPS, TXCPA Chairman-elect Jason Freeman, JD, CPA-Dallas, and Eric Curtis from Curtis Strategy shared updates on TXCPA's Strategic Plan. TXCPA's Strategic Planning Committee and the TXCPA Executive Board gathered input from the 20 local chapters, the Board of Directors and members at large to assist in the development of the new plan.

TXCPA's mission, vision, commitment to diversity, equity, inclusion and belonging, strategic pillars and guiding principles remain as foundational elements of the strategic plan. New in the 2020-2024 plan are three specific goals that focus on achieving our strategic destination as a unified, influential and adaptive association driven by technology to deliver customized value and service to the evolving accounting profession.

Our chapters' work under the three strategic pillars of Community and Connection, Professional Excellence and Advocacy will continue to support and contribute to the collective efforts of TXCPA members across the state. For more information and available resources for the strategic plan, go to https://www.tx.cpa/about/governance/strategic-plan.

### Outstanding Accounting Educator Award

TXCPA Chairman Jerry Spence, CPA-Corpus Christi, presented the Outstanding Accounting Educator Award. This award recognizes Texas accounting educators who have demonstrated excellence in teaching and have distinguished themselves through active service to the accounting profession. The recipients are:

- **Michelle Avila**, CPA-San Antonio – Associate Professor of Accounting and Program Head of Accounting at Our Lady of the Lake University in San Antonio;

- **Dr. Marina Yordanova Ruseva**, CPA-Southeast Texas – Assistant Professor at Lamar University's College of Business.

Criteria for judging include instructional innovation, student motivation and learning opportunities, professional and student accounting organization involvement, research, and publications. Congratulations to this year's recipients!

### Diversity, Equity, Inclusion and Belonging

Diversity and Inclusion Committee Chair Lisa Ong, CPA-Dallas, and committee member John Baines, CPA-Dallas, shared updates on the Society's work in the area of Diversity, Equity, Inclusion and Belonging.

TXCPA's top priorities in this area include:

- Increase Visibility of Diverse Volunteer Leadership;
- Cultivate Inclusive Leadership Skills;
- Align Chapters With D+I Priorities;
- Expand the CPA Pipeline; and
- Identify Diverse Members for Civic Leadership.

Our work and commitment to diversity and inclusion are more important than ever before. We see this as a strategic priority for the accounting profession and as a driver of next generation membership. It's not only critical for the profession, but in our communities as well.

### Other Business

Other important business at the meeting:

- Sheila Enriquez, CPA-Houston, CFF, CVA, was introduced as 2021-2022 Chairman-elect;
- NASBA Chair Carlos Barrera, CPA; TSBPA Presiding Officer Manny Cavazos, CPA-Austin; and AICPA Chair Tracey Golden, CPA, CGMA, discussed the future of the profession;
- Nominations Committee Chair Lei D. Testa, CPA-Fort Worth, CGMA, gave the Nominations/Elections Report;
- Chairman-elect Jason Freeman, JD, CPA-Dallas, discussed the Chairman-elect's Appointees;
- Treasurer Susan Roberts, CPA, CGMA, and TXCPA CFO Edie Cogdell, CPA, CGMA, gave the Treasurer's Report.

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### Annual Meeting of Members

Save the date for TXCPA's Annual Meeting of Members. It will be held on June 25-26, 2021. Look for more details about the meeting coming soon!

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# CYBERATTACKS AND RANSOMWARE DEMANDS ON MUNICIPAL GOVERNMENTS AND SMEs

**By Kamala Raghavan, CPA, CFP, CFF, CGMA**

Municipal governments and small to medium (SME) enterprises are facing an escalating number of cyberattacks and ransom demands. These attacks are crippling their systems and costing them funds that could be deployed to increase stakeholder services. "Ransomware is a pandemic in the United States," said Joel DeCapua, supervisory special agent in the Federal Bureau of Investigation's cyber division referring to the malicious software deployed by hackers who are increasingly going after smaller targets.

Municipal governments and SMEs are attractive targets for the criminals due to their vulnerable technology infrastructure and weak cybersecurity protocols as compared to the corporate sector. These organizations are increasingly using loosely integrated networks of information systems to deliver services to stakeholders and are generally not prepared to combat data breaches due to limited resources. They are also relying increasingly on small third-party outsourced technology providers who are not able to protect sensitive stakeholder information.

It's hard to quantify the total impact of ransomware attacks because most are not publicly reported. This article discusses several incidents and offers a suggested preventive, detective and corrective procedures' framework for use by managers and auditors in reviewing and monitoring compliance, with the goal of avoiding expensive corrective actions after the incident.

## Current Situation

While most ransomware attacks of earlier years targeted home computers, the attackers have moved to the more attractive targets of municipal governments and SMEs, which face pressure to resume services to their stakeholders quickly for their survival. The recent attacks from state-sponsored hackers have been targeting the bigger prize of the U.S. federal government to gain access to defense secrets and citizens' data more and more. So far, these attackers have not demanded ransom money but seem to be more interested in accessing the U.S. defense and research data.

This article focuses only on the lesser scope of municipal and SME security breaches for ransom money. Following are examples of some attacks:

- Travelex, the foreign exchange shop operator, was infiltrated in January 2020 by hackers and had to pay about $2.3 million in ransom. It was attacked by a malware known as "Sodinokibi."
- In June 2019, two Florida cities, Lake City and Riviera Beach, had their 911 systems compromised and the systems could not be operated. Lake City paid $460,000 in cryptocurrency and Riviera Beach paid $600,000 in bitcoin.
- Hackensack Meridian Health in New Jersey suffered a ransomware attack in December 2019. The attack forced cancellation of surgeries and other procedures. The hospital system paid an undisclosed amount to the hackers, worked to restore its computer networks over a few weeks, and hired cybersecurity and forensic experts to investigate.
- The cyberattack on the City of Atlanta's network happened in March 2018 and a federal grand jury in Atlanta indicted two Iranian nationals in December. Both men remain wanted by the FBI. The City of Atlanta refused to pay a ransom of $51,000 in bitcoin and suffered millions of dollars in losses from the attack.
- Imperial County, California suffered a breach in April 2019, with hackers demanding payment of $1.2 million. Secure backup data helped the county avoid paying the ransom, and the county spent about $1.6 million to beef up equipment and security. The costs were largely covered by a cyber-insurance policy.

### Table 1.

### Preventive, Detective and Corrective Procedures to Monitor – Management

- ✔ Ensure collection and correlation of data across sources.
- ✔ Train a talented workforce.
- ✔ Keep systems, network and malware definitions up to date.
- ✔ Invest in staff training, especially in cybersecurity.
- ✔ Follow a strict data protection process, including analyzing system vulnerabilities frequently, keeping systems updated and data files backed up regularly.
- ✔ Promote data-driven decision-making.
- ✔ Install software for regularly scanning systems for viruses and malware.
- ✔ Monitor cybersecurity assessment and conduct frequent cybersecurity audits.
- ✔ Communicate with stakeholders.
- ✔ Ensure that tape and disk-based backups are encrypted to deter easy access to data, and that offline and online backups of critical data are kept.
- ✔ Implement multifactor authentication for all crucial data and login protocols.
- ✔ Have an incident response team in place with a team leader designated and an incident response plan. Keep a hard copy of the incident response plan available and have a predesignated site for the incident response team to gather.
- ✔ Have a public relations and communication plan to inform law enforcement and other interested parties.
- ✔ Ensure that internal auditors are trained to provide guidance on best practices to protect the organization moving forward.

**Article continues on page 17**

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- The City of Baltimore suffered an attack on May 7, 2019, with more than one group breaching the computer network. The attack delayed home sales and prevented the city from issuing water bills. The computer and email access for some employees was restored after a few months. Baltimore refused to pay a $76,000 ransom but estimated that the attack cost $18.2 million in losses and restoration expenses.

## Risk Factors and Surveys

Municipal governments and SMEs operate networks of disparate and loosely connected information systems to deliver services to stakeholders efficiently but have limited cybersecurity talent and financial and software resources. Most ransomware attacks happen when an employee unknowingly opens a link or an attachment in a phishing email or are the result of a vulnerable cybersecurity system. The ransomware blocks data files and the attackers send demands for the files to be unlocked in return for a payment, typically in cryptocurrency.

An Accenture security survey of more than 2,600 security professionals from 355 companies in 11 countries in various industries found that the average annual cost of cybercrime per company jumped from $11.7 million in 2017 to $13 million in 2018. The study included four categories of internal activity: cybercrime discovery, investigation, containment and recovery. The authors estimated the total value at risk from cybercrime in the next five years at $5.2 trillion.

IBM's "Cost of a Data Breach Study" by the Ponemon Institute in 2018 found that the average cost of a data breach globally increased 6.4% year over year to $3.68 million. With one million records breached, the average total cost from the incident is $40 million and with 50 million records, the cost becomes $350 million. The likelihood of a recurring breach is 27.9%. The Ponemon Institute survey estimates that 70% of small and medium sized businesses report experiencing a cyber-attack.

Verizon's 2019 Data Breaches Investigation Report found that 43% of cyber-attacks are targeted at small businesses. And in its report entitled "Seven Hidden Costs of a Cyber-attack," Deloitte listed the following as costs: investigation, cost from loss of customer confidence, regulations, legal costs, public relations, hardware and software changes, insurance, reputational loss, debt and equity costs, contract losses, etc.

In addition, reconciliation and remediation costs can run quite high even after paying the ransom.

Government organizations and SMEs face tough decisions when it comes to balancing crippled operations to stakeholders versus paying off hackers to try to limit damage. There is no guarantee that payment of ransoms will lead to recovery of data. The global survey by Cyber Edge in 2018 found that 40% of victims that paid a ransom did not get their data back.

Many of the ransomware attacks exploit the weaknesses in the systems of Managed Service Providers (MSP) used by municipal governments and SMEs to reduce costs. While many MSPs offer reliable support and data storage, they provide a convenient pipeline for hackers to infect many computers in a single attempt.

A typical example was the attack on 23 Texas cities and towns using the vulnerabilities in their MSP, TSM Consulting Services. One town was hit with ransomware twice in the past year through TSM. MSPs that are lax with clients' backup and their own cybersecurity protocol end up paying ransoms to the attackers, thereby rewarding the attackers. Attackers have capitalized on preventable security weaknesses such as weak passwords and lack of two-factor authentication in the MSP's operations.

The most widely used malware Ryuk is based on the source code of an earlier ransomware called Hermes found in Russian cybercrime forums. Ryuk is deployed through a multistep campaign to get deep into the organizations' systems using remote access, gathering information and releasing ransomware.

Ryuk's victim list includes Onondaga County Public Libraries, the Syracuse public school system, the Butler County federated library system in Pennsylvania, and Collierville, Tennessee. The list is expanding due to the poor cybersecurity protocol at smaller organizations, their MSPs and lack of in-house technology professionals.

Ransomware attacks are also exposing the weaknesses in state-owned enterprises' systems as witnessed by the 2019 attack on the

CONGRATULATIONS TO DR. KAMALA RAGHAVAN ON BEING ELECTED TO THE FULBRIGHT ASSOCIATION BOARD OF DIRECTORS!

## Table 2.

### Preventive, Detective and Corrective Measures to Monitor – Audit

- ✔ Review organization chart of management and certifications of IS personnel.
- ✔ Review minutes of board governance, technology and audit committees.
- ✔ Review IS operating policies, including due diligence in vendor management and core software vendor release updates.
- ✔ Review insurance policies on equipment and facilities, business interruption and fraud.
- ✔ Review contracts with third party data processor, software and hardware service providers.
- ✔ Review the disaster recovery programs and testing of the above vendors.
- ✔ Review policies for software update installations and test compliance.
- ✔ Review management of software licenses.
- ✔ Test and verify acquisition of new and existing technology equipment and software, and the development of data mining and reports.
- ✔ Review separation of duties and permissions granted to personnel.
- ✔ Review and test information security and risk management programs.
- ✔ Review controls on network access, firewalls, reports and documentation.
- ✔ Test, or at a minimum review, reports on vulnerability assessments.
- ✔ Review and test physical security measures.
- ✔ Review documentation on standards and policies and ensure that they are updated.
- ✔ Review business continuity plans, including hot site readiness and vendor agreements.

state-owned oil and gas company, Petroleos Mexicanos, disrupting its billing systems and affecting supply chain operations. Norse Hydro ASA, Saudi Aramco and Rosemont PJSC were also attacked.

Such attacks on state-owned entities make one wonder if their safety procedures are worse than their corporate counterparts.

## Risk Reduction Strategies

Preventive and detective steps can deflect ransomware attacks and minimize the damages to organizations. Preventive steps include purchasing cyber insurance, hiring technology talent including artificial intelligence (AI), and training of staff in basic system hygiene.

Many large U.S. cities and SMEs have purchased cyber insurance. For example, Houston has purchased a $30 million cybersecurity insurance policy with $471,400 annual premium, while Boston, Nashville, Dallas, Denver, Detroit, San Diego, San Jose, and Washington D.C. are in the process. However, cyber insurance can act as a double-edged sword by providing a false sense of protection and encouraging the hackers to increase the attacks aggressively.

As municipalities and SMEs struggle to deal with ransomware attacks, many of them are looking at AI as the tool to quickly detect the malware and stop it from spreading. Detective procedures are being developed by vendors using AI to detect abnormal usage patterns and deflect the attacks quickly.

The city of Las Vegas has added AI to the city's cyber defenses over the past three years to detect and respond to threats. AI tools can detect irregular network behavior and automatically quarantine an infected device before the malware has a chance to compromise other equipment. AI can automatically take control and react to the threat instantly to prevent extensive damage.

The coordinated ransomware attack on 23 municipalities in Texas led to the Texas State government ordering "Level 2 Escalated Response." However, the most important lesson to be learned

from the incident is the vigilance in thwarting the ransomware attacks by Lubbock County, where the in-house technology personnel shut down the affected computers and prevented major losses in services and time. In contrast, the other 22 cities, including Borger, Keene and Wilmer, suffered major damage to their services due to lack of the preventive measure.

If they do not take actions, there are indications that the risk will be factored into increased cost of their debt by the capital markets and increased regulatory oversight.

In the future, stakeholders can and will hold auditors of these organizations accountable for reviewing and monitoring compliance with the cybersecurity framework.

**IT IS STILL HARD TO QUANTIFY THE TOTAL IMPACT OF RANSOMWARE ATTACKS BECAUSE MOST ARE NOT PUBLICLY REPORTED.**

Table 1 and Table 2 show some basic preventive, detective and corrective procedures to be adopted by management and audit to minimize the threat and cost to stakeholders.

The framework of procedures for management and audit discussed in Tables 1 and 2 are meant to be the minimum level of protection to be implemented by municipal governments and SMEs. The size and complexity of the organization should determine additional procedures to be considered.

## Attractive Targets

Municipal governments and SMEs are attractive targets to fraudsters and hackers to launch ransomware to infect many users quickly. Due to their vulnerable cybersecurity infrastructure planning, these organizations struggle to counter the threats and recover to a normal state. Such attacks are increasing and depleting precious funds that could be deployed on services to stakeholders.
Managers must implement the preventive, detective and corrective procedures quickly and consistently.


**ABOUT THE AUTHOR:**

*Dr. Kamala Raghavan is professor and interim department chair for Finance and Accounting at Texas Southern University's Jesse H. Jones School of Business. She was elected to the Fulbright Association Board of Directors under the leadership of Executive Director Dr. John Bader. The mission of the Fulbright Association is to advocate for the Fulbright program and promote international education. She began her three-year term January 1, 2021. Contact Dr. Raghavan at kamala.raghavan@tsu.edu.*


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FEATURE

# Economic Stimulus and Tax Extenders Ride the Coattails of Government Funding in the CONSOLIDATED APPROPRIATIONS ACT, 2021

By Don Carpenter and Tim Thomasson

In the waning days of 2020, President Trump signed into law the Consolidated Appropriations Act, 2021 (the Act), a $1.4 trillion omnibus spending bill that provides appropriations for funding 12 government departments. But this was overshadowed by the additional $900 billion included in the bill as a second round of economic stimulus in response to the pandemic, and new and extended tax provisions intended to advance the nation's combined energy policy and further assist struggling families.

## Pandemic Relief for Individuals with $600 Direct Payment

Modeled after the earlier stimulus checks disbursed in the spring of 2020, $166 billion of the pandemic relief appropriation was dedicated to direct payments to taxpayers. This provision was the focus of considerable debate.

Ultimately, it was settled that single taxpayers reporting up to $75,000 of adjusted gross income (AGI) on their 2019 income tax return would receive the full $600 payment with the amount being reduced ratably until full phase out at $87,000 of AGI. Married couples filing jointly receive $600 each if AGI does not exceed $150,000 with full phase out set at $174,000.

The payments to those qualifying as heads of household begin phase out at AGI of $112,500 (full phase out at $124,500). The remittance also includes $600 for each dependent child below 17 years of age. Eligible individuals must have a valid Social Security number and not be a nonresident alien or claimed as a dependent by anyone else. Each dependent child must also have a valid Social Security number or adoption taxpayer identification number.

The Department of Treasury was authorized to make advance payments based on taxpayers' 2019 tax returns. Remittances were to be made via direct deposit for taxpayers for which the IRS has bank account information. All others would receive either paper checks or debit cards. Taxpayers who qualify but did not receive payments can claim the amount as a credit on their 2020 income tax return filed in 2021.

Taxpayers will not be required to repay an advance stimulus payment that exceeds the amount of their eligible credit.

## Other Provisions Target Specific Needs

In addition to stimulus checks, $120 billion was allocated for supplemental unemployment benefits:

- The federal assistance will provide $300 per week to supplement state funded benefits for the period December 26, 2020 through March 14, 2021.
- Benefits are also available to self-employed individuals who self-certify that they have been impacted by COVID-19.
- Maximum number of weeks an individual can claim benefits was extended to 50 weeks.

The Act also extended the national eviction moratorium that was put in place under the CARES Act. CARES delayed evictions for federally backed properties, which was then extended to all properties by the Centers for Disease Control and Prevention in September 2020. The moratorium, which was set to expire on December

31, was extended by a month to the end of January. The provision did not forgive past-due payments or related charges which become due at expiration.

In addition, the Act appropriated $25 billion for state and local governments to provide emergency rental assistance. To qualify, renters must spend 90% of any assistance received on rent (including past due payments), utility costs and costs associated with COVID-19. States are required to prioritize low income and unemployed renters.

## Surprise Medical Billing Also Addressed

Although a focus for several years, Congress finally acted to address charges by health care providers for unexpected or excessive costs typically arising from out-of-network services. These costs generally arise when individuals are in emergency situations or have no other care alternatives. The charges are often incurred without prior knowledge or consent. The costs are not covered by the patient's health plan and result in unexpected bills that can run to thousands of dollars.

The new restrictions become effective in 2022 and prohibit individuals from being charged out-of-network rates without consent for emergency care, air ambulance transport or when receiving non-emergency care at an in-network facility by out-of-network professionals.

In addition, the excess costs cannot be charged to the individual's employer through an appeals process. Out-of-network costs will be required to be resolved through an arbitration procedure that must use median in-network rates as a guideline for dispute resolution. Guidance on these regulations will be forthcoming and will likely require health plans to be amended to conform to the provisions.

## Paycheck Protection Plan (PPP) Round 2 Headlines Relief for Small Businesses

Not only did the Act allocate $284 billion for additional loans to qualified borrowers, it also clarified one of the most controversial aspects of the CARES Act.

### Charitable Giving

The Act enhances tax incentives for charitable giving. CARES allows taxpayers who do not itemize their deductions to take up to a $300 deduction for AGI attributable to cash donations made to qualified charitable organizations in 2020. The Act extends this opportunity for cash donations made through December 31, 2021. The $300 limit remains intact.

In addition, CARES allowed taxpayers to substitute 100% for 60% when calculating the AGI limit for cash contributions made in 2020 to certain qualified charitable organizations. The Act extends this election for contributions made in 2021, as well.

The CARES Act provided for loan forgiveness if no less than 60% of the loan amount was used to meet payroll over a covered period of either eight or 24 weeks. This provision is also available for loans issued under the current Act. But in Notice 2020-32 (and affirmed in Rev. Rul. 2020-27), the IRS took the position that any expense paid with proceeds of a forgiven PPP would not be tax deductible in spite of Congressional statements to the contrary.

The second round of PPP makes significant modifications to the earlier program. In addition to first-time borrowers, businesses that received a loan under CARES may also apply. However, previous recipients are limited the lesser of 2.5 times the average monthly payroll costs for the 12 months preceding the loan (or 2019) or $2 million and must meet the following criteria:

- Must have 300 or fewer employees;
- Must have used or will use the full amount of their first PPP loan;
- Demonstrate that revenue declined by at least 25% in any quarter of 2020 when compared to the same quarter in 2019.

The qualified expenses that may be covered by the loans have also been expanded under the new program. The first round of loans was intended to cover payroll, rent, mortgage interest and utilities.

In the second round, the proceeds may also be used for:

- Worker protection, such as personal protective equipment;
- Facility modifications to meet COVID-19 safety requirements;
- Software, cloud computing and accounting costs that facilitate business operations;
- Property damage costs due to looting or vandalism from public disturbances in 2020 not covered by insurance.

The Act also allows the borrower the option to choose any period beginning on the loan origination day and lasts between eight and 24

weeks, not just either eight or 24 weeks as in the prior round.

For loans of $150,000 or less, there is an expedited forgiveness process. The application for forgiveness will be an attested self-certification that provides the number of employees the business was able to retain as a result of the loan and the estimated amount of the loan used for payroll.

Two additional loan programs target specific businesses. An additional $20 billion was appropriated to fund the Small Business Administration's Economic Injury Disaster Loan (EIDL) program for small businesses in low-income communities. Applications can now be made for low interest rate loans with 30-year maturities through December 31, 2021.

To qualify, the business must:

- Have no more than 300 employees;
- Be located in a low-income community as defined by the new markets tax credit; and
- Experience a decline in gross receipts of at least 30% during an eight-week period from March 2, 2020 to December 31, 2021 when compared to a comparable period in 2019 or 2020 prior to March 2.

Each applicant is limited to a loan of $10,000, which is reduced for any amount received under the CARES Act allocation.

An additional $15 billion was appropriated to assist live-performance venues, movie theaters and museums. To qualify, the venue had to be fully operational on February 29, 2020. The initial grant is equivalent to 45% of 2019 revenue. A supplemental grant is available that is limited to 50% of the initial grant if the venue experienced revenue loss of at least 80% as of December 1, 2020. Taken together, the grants are capped at $10 million.

Businesses experiencing at least 90% revenue loss could apply within two weeks of the Act becoming law. All others that experienced at least 25% revenue loss could apply thereafter.

To qualify, a business cannot also receive a PPP loan.

## Other Business Provisions Further Encourage Retention of Employees

Many of the business provisions of pandemic relief focus on employee retention. The Act extended the employee retention tax credit and the deferred payroll tax provisions of CARES.

The employee retention tax credit that was set to expire on December 31, 2020 has been extended to June 30, 2021. The credit is also increased to 70% of qualified wages from the 50% credit provided under CARES.

### Home Ownership

Prior tax law provided taxpayers an exclusion from gross income for forgiveness of qualified principal residence indebtedness up to $2 million ($1 million for married individuals filing separately). This exclusion would have expired for debt forgiveness arising after December 31, 2020. The Act extends this exclusion through December 31, 2025 but reduces the maximum amount to $750,000 ($375,000 for married individuals filing separately).

In addition, the Act extends for one year the itemized deduction for home mortgage insurance premiums. This deduction, which is subject to phase-out for higher-income taxpayers, would have expired at the end of 2020.

Finally, the Act extends the nonbusiness energy property credit by one year. This credit, which is available for purchases of qualifying energy property to be used in a taxpayer's principal residence, was also set to expire at the end of 2020.

It is capped at $7,000 per eligible employee ($10,000 wages X 70%) for each of the first two quarters of 2021 for a maximum credit of $14,000 per employee. The credit is not reduced for any amounts received under the CARES Act in 2020.

Several significant modifications to the credit when compared to the CARES Act retention credit should be noted:

- To be eligible, a business must be fully or partially suspended under a COVID lockdown order or, under CARES, the business must have experienced a reduction in gross receipts for the quarter of at least 50% when compared to the prior year quarter. The new Act requires a reduction of only 20%.
- Under CARES, any business that received a PPP loan could not also claim the credit. This has been amended under the Act to allow a credit for any wages paid that are not funded by a forgiven PPP loan. **The change is retroactive to 2020 wages, so companies should determine if there were excess qualified wages and consider filing amended payroll tax returns to claim the 2020 credit.**
- Under CARES, the credit could only be claimed for businesses with 100 or more employees for wages paid when employees were not providing services. The restriction did not apply to smaller businesses. The ACT raises the threshold to 500 or more employees.
- In 2020, the credit did not apply to any pay increases. Under certain circumstances, pay increases will qualify in 2021.
- For businesses with less than 500 employees, a mechanism will be put in place to allow for receipt of the credit prior to paying the qualified wages, which was not provided in 2020. Any overpayment of the credit will have to be repaid.
- The credit has also been expanded to include certain governmental entities such as hospitals, universities or federal credit unions.

A separate credit for paid sick leave or family leave connected to COVID-19

that was provided under the Families First Coronavirus Response Act for businesses with less than 500 employees has been extended from December 31, 2020 to March 31, 2021.

In August 2020, President Trump issued a Presidential Memorandum providing for the deferral of the withholding, deposit and payment of certain payroll tax obligations. The Treasury Department subsequently issued Notice 2020-65, indicating these provisions would, at the option of the employer, apply to an employee's 6.2% portion of Social Security (OASDI) taxes on wages paid between September 1 and December 31, 2020 for any employees whose wages were less than the equivalent of $4,000 for a bi-weekly pay period.

Since this was a deferral and not an abatement, the taxes were to be withheld ratably from wages paid from January 1 to April 30, 2021, in addition to normal taxes required on those wages. The Act extended the catch-up period to include pay periods from January 1 until December 31, 2021.

## The Act Also Contains Many Tax Provisions Impacting Individuals and Businesses

The Act includes a combination of routine, year-end tax extenders, enhancements to provisions enacted with CARES and new provisions attributable to the COVID pandemic. We have mentioned some of the provisions above. While the discussion below does not cover every tax provision in the Act, we discuss the ones we think will be most relevant to practitioners.

## Individuals May Benefit from Additional Exclusions, Deductions and Credits

Many of the provisions target additional relief related to the COVID pandemic. We have already mentioned the second stimulus payments above. Although not specifically a tax provision, the filing of the 2020 tax return will be one mechanism certain taxpayers may utilize to receive any additional stimulus payment due. Some of the other more relevant forms of relief are discussed below.

Educators (kindergarten through the 12th grade) are allowed a deduction in arriving at AGI for certain unreimbursed business expenses, not to exceed $250 a year. Qualified expenses will now include personal protective equipment, disinfectant and other supplies used for the prevention of the spread of COVID-19, as long as these expenses are paid after March 12, 2020.

In the area of higher education, the Act repeals (by not extending) the deduction for AGI of qualified tuition and other qualified higher education expenses. This deduction was originally set to expire at the end of 2017 but had been extended for each of 2018, 2019 and 2020.

In addition, under pre-CARES and pre-ACT, qualified education assistance provided by an employer was exempt from an employee's gross income, up to a certain threshold. CARES expanded the definition of qualified education assistance to include student loan payments made either to the lender or the employee after March 27, 2020 and before January 1, 2021. The Act extends the inclusion of these loan payments in the definition of qualified education assistance through December 31, 2025.

Although not specific to COVID but related to higher education, changes are in store for education credits, as well. Previously, the Lifetime Learning Credit (LLC) was subject to a lower phase-out range than the American Opportunity Tax Credit (AOTC). The Act provides that the LLC is now subject to the same, higher phase-out range as the AOTC.

Taxpayers within certain ranges of earned income are eligible for


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refundable child tax and earned income credits. Under the Act, taxpayers can elect to substitute earned income from 2019 for 2020, if the amount from 2019 is higher. This election may help taxpayers experiencing lower AGI in 2020 due to the pandemic.

Given the pandemic and disruption or loss of wages, medical costs currently represent a significant burden on many taxpayers. The Act contains four key provisions that provide some relief. The AGI threshold for deducting medical expenses from AGI was previously set to increase from 7.5% to 10% for tax years beginning after December 31, 2020. The Act makes the more beneficial 7.5% threshold permanent.

Also, the health coverage tax credit (HCTC) was due to expire December 31, 2020. The Act extends the HCTC, which provides a refundable credit to certain individuals for health insurance, through December 31, 2021. Individuals who participate in either health or dependent care flexible spending accounts (FSAs) through their employer now have a longer grace period to utilize unused benefits or contributions to these accounts. The Act allows employers to extend the grace period by 12 months for 2020 and 2021.

Accordingly, an employee now has until December 31, 2021 to utilize unused contributions to, and benefits from, an FSA in 2020. Likewise, an employee has until December 31, 2022 to utilize such unused contributions and benefits from an FSA in 2021. The employer must allow for these extended grace periods.

## Additional Disaster Relief is on the Way

The Act provides tax relief in a couple of ways for taxpayers experiencing hardship attributable to a loss arising from a federally declared disaster.

Under pre-Act law, individual taxpayers could claim an itemized deduction for personal casualty losses attributable to a federally declared disaster. However, each loss was subject to a $100 floor and the itemized deduction only applied to the extent the sum of all eligible net casualty losses exceeded 10% of a taxpayer's AGI.

Under the Act, such losses are now subject to a $500 floor. However, these losses will not be subject to the 10% of AGI reduction. Also, if a taxpayer does not claim itemized deductions, the net casualty losses can be added to the standard deduction.

Taxpayers under the age of 59.5 are generally subject to a 10% early distribution penalty for distributions from an employer retirement plan. The Act excludes a "qualified disaster distribution" from the 10% penalty. In addition, the taxable amount of any such distribution can be included in gross income ratably over a three-year period, beginning in the year of distribution.

**The Act clarifies that no deduction will be denied nor will any gross income be included as a result of the forgiveness of a PPP loan.**

A "qualified disaster distribution" is one made to a taxpayer who resides in a federally declared disaster area and suffers a loss resulting from such disaster, and is made during the period beginning with the first day of the disaster and ending 180 days after the enactment of the Act. There is a $100,000 limit, cumulative for all tax years, on the amount of distributions eligible for this relief.

## Many Provisions Will Have a Favorable Impact on Businesses

We mentioned above what is likely the biggest tax news for businesses. The Act clarifies that no deduction will be denied for otherwise deductible costs attributable to PPP loans that are ultimately forgiven. This removes uncertainty for tax practitioners who otherwise were faced with many compliance issues, especially when the debt forgiveness occurs in 2021 but the expenses were incurred in 2020.

We also discussed above the extension of the employee retention tax credit. In addition, the Act extended the employer credit for paid family and medical leave through 2025. This elective benefit provides employers with a tax credit for wages paid to qualified employees on family or medical leave. This credit is a percentage of the underlying wages, beginning at 12.5% if the paid leave is at least 50% of such wages. The credit increases as the paid leave as a percentage of normal wages increases but is capped at 25%. An employer may take this credit for up to 12 weeks of paid leave per employee.

The Act also provides an expanded charitable contributions deduction for corporations. Under pre-Act and pre-CARES law, a corporation's charitable contribution deduction was limited to 10% of adjusted taxable income, with any disallowed contributions eligible for a five-year carryforward. CARES allowed corporations to disregard the 10% limitation for cash contributions made to 50% charitable organizations. Such contributions, however, could not exceed the excess of 25% of a corporation's adjusted taxable income over all other contributions deducted in 2020.

The Act now allows a corporation to deduct qualified disaster relief contributions up to 100% of adjusted taxable income. Qualified disaster

relief contributions must be paid during a period beginning January 1, 2020 and ending 60 days after the enactment of the Act. The contribution must be made for relief efforts in a federally declared disaster area. A corporation is also required to obtain written documentation from the recipient confirming that the contribution will be used for disaster relief.

Both the work opportunity tax credit and the new markets tax credit programs, originally set to expire at the end of 2020, are extended through 2025. The work opportunity tax credit provides employers with an elective tax credit based on first-year wages paid to new hires from 10 targeted groups. The new markets tax credit, which applies to individuals as well, is equal to 39% of capital invested in a qualified community development entity. A qualified community development entity must loan or invest substantially all of its capital in businesses operating in low-income communities.

## Additional Provisions Support Energy Efficiency

The Act continues the trend of supporting the efficient use of energy. The energy efficient commercial buildings deduction under IRC Section 179D, originally set to expire December 31, 2020, is now permanent. This law allows businesses to immediately deduct energy efficient improvements to lighting, heating, cooling, ventilation and hot water systems of commercial buildings.

The deduction ranges from $0.60 to $1.80 per square foot of construction, determined by whether or not the entire building meets certain energy standards. In addition to making this deduction permanent, the Act adds an inflation adjustment.

Several other tax credits related to energy efficiency, originally set to expire at the end of 2020, were extended. These include the:

- Credit for electricity produced from certain renewable resources, such as wind and solar energy;
- Second-generation biofuel producer credit;
- Alternative fuel refueling property credit; and
- Excise tax credit relating to alternative fuels.

There are other notable extensions through 2025 in the Act attributable to businesses. These include the following:

- The look-thru rule for related Controlled Foreign Corporations for purposes of determining the deemed inclusion under Subpart F;
- Seven-year recovery period for motorsports entertainment complexes;
- Deduction (up to $15 million) for qualified film, television and theatrical productions;
- Various empowerment zone tax incentives; and
- The carbon oxide sequestration credit.

These extensions apply through the end of 2021:

- The Indian employment credit (extended for one year);
- The mine rescue team training credit (extended for one year);
- Three-year recovery period for race horses two years old or younger (extended one year); and
- Accelerated depreciation for business-use property located on an Indian reservation (extended one year).

For an election year, 2020 saw major economic and tax legislation. The Biden administration also promised that this is not the end of government assistance to buttress the economy and assist struggling families. With that in mind, 2021 promises to be just as interesting.

### A Boost for the Dining Food Service Industry

One of the provisions receiving the most publicity is a temporary lifting of the 50% limit on the deductibility of business meals provided by a restaurant for 2021 and 2022. In addition to providing tax relief to businesses, this provision is intended to boost the struggling food service industry.

This benefit applies not only to meals on the restaurant's premises, but also to takeout and delivery services. Businesses must continue to meet the existing requirements for the deductibility of meals. Therefore, the meals cannot be lavish or extravagant, the business owner or an employee must be present, and the substantiation requirements still apply.

Entertainment expenses will continue to be nondeductible. If food or beverages are provided in conjunction with an entertainment activity, either they must be purchased separately from the entertainment or their cost must be separately stated on the bill. While businesses certainly welcome this temporary relief, they will need to quickly implement procedures to properly track meals eligible for the 100% deduction.

**ABOUT THE AUTHORS:**

*Don Carpenter, MSAcc/CPA, is clinical professor of accounting in the Hankamer School of Business at Baylor University. Contact him at Don_Carpenter@baylor.edu.*

*Timothy S. Thomasson, CPA, MTAX, is Graduate Program Director and an associate clinical professor in the Hankamer School of Business at Baylor University. He is also a practicing CPA. Thomasson can be reached at Timothy_Thomasson@baylor.edu.*

FEATURE

# Self-Directed Solo 401(k) Retirement Plans: The Underutilized Efficiency-Maximizer

## The little-known Self-Directed Solo 401(k) could create a tax-deferral and investment diversification winning combination

**By Whitney Nash, CPFA**

"How can I save money on my taxes?" CPAs are frequently asked this question and are expected to share ideas and options on how to maximize deductions, lower taxable income, and reduce and/or defer tax liabilities. Suggesting the adoption of a retirement plan to their business-owner clients is often a viable recommendation. The plan that is recommended, however, makes a big difference. When it comes to clients who have income from self-employment as 1099 independent contractors, or business owners with no W-2 employees working more than 1,000 hours per year, this is especially true.

It is common for CPAs to recommend SEP IRAs or Solo 401(k)s to this type of client, among a few other less popular options. Both offer high contribution limits and other beneficial provisions, but they are still lacking in one way or another. The SEP IRA does not permit loans to be taken out or elective salary deferral contributions, so Roth and catch-up contributions cannot be made. The Solo 401(k) offers loan and salary deferral options, but it does not allow the client/account holder to be the trustee and self-direct funds to be invested in alternative assets, such as real estate, certain businesses, hard money lending, etc. (See Figure 1 for a side-by-side comparison chart.)

With the growing popularity of portfolio diversification into alternative asset classes, real estate in particular, the Self-Directed Solo 401(k) might be a welcome alternative.

CPAs who gain an understanding of this underutilized strategy could position themselves as a great resource to help their clients who meet the eligibility requirements, the pool of which is growing.

### Eligibility Requirements to Adopt a Self-Directed Solo 401(k) Plan

To determine if someone qualifies for a Self-Directed Solo 401(k), two criteria must be met. First, they

must have earned income from self-employment. Keep in mind, Schedule E (rental, dividend and royalty) income does not qualify. It does not matter what their entity type is or if they are a sole proprietor.

Second, the business owner, or 1099 independent contractor, cannot have any W-2 employees working more than 1,000 hours per year. Businesses with partners as the only full-time workers, spouses who are employees or partners, and full-time 1099 independent contractors working with the business are all acceptable and do not negate eligibility.

The business owner just cannot have any W-2 employees working more than 1,000 hours per year ... for now. The SECURE Act changed the 1,000 hours per year rule. It states that retirement plans will need to be offered to part-time employees who have "... three consecutive 12-month periods during each of which the employee has at least 500 hours of service" (see Neal, Richard E. "Text - H.R. 1994 - 116th Congress (2019-2020): *Setting Every Community Up for Retirement Enhancement Act of 2019*." Congress.gov, 3 June 2019, https://bit.ly/3esPyft) and who satisfy the plan's minimum age requirement of 21 years of age.

Hours of service during 12-month periods before January 1, 2021, will not be considered. The clock started on January 1, 2021, so these plans will not be affected until January 2024. The IRS is expected to release more guidance on this new rule. See Section 112 of the Act for more information: https://bit.ly/3esPyft.

Spouses and business partners who earn income from the business can each have their own account under the Self-Directed Solo 401(k) plan. In the case of spouses, this could possibly double, or more depending on age, the contribution limits and tax-deferral amount for their household. Any 1099 independent contractors working with them can adopt their own plan for their business, as well.

If the account holder also has a W-2 job, they can still have a Self-Directed Solo 401(k) plan and contribute to their W-2 employer's plan, per the applicable allocation rules and combined contribution limit for elective salary deferral. It is important to note that control group issues could affect eligibility, so each client's circumstances will have to be considered.

## Contribution Types Allowed and Limits

The Self-Directed Solo 401(k) allows for pre-tax contributions to be made two different ways: Salary Deferral and Profit-Sharing.

**Figure 1.**

### HOW THEY ARE DIFFERENT

| SEP IRA | S-D SOLO 401(K) |
|---|---|
| Is it OK to have full-time W-2 employees | Is it not OK to have full-time W-2 employees working >1,000/yr |
| Loans are not allowed | Loans are allowed, per applicable rules and limits |
| Salary deferral contributions cannot be made, so no Roth option or catch-up for those 50+ | Includes salary deferral, so it allows for Roth and catch-up for those 50+ |
| Does not allow for voluntary after-tax contributions | Voluntary after-tax contributions are allowed |
| Account holder cannot be the trustee or custodian, which will increase the cost | Account holder is the trustee and no custodian is needed, which keeps the cost low |
| Is subject to Unrelated Debt-Financed Income Tax (UDFI) | Is not subject to Unrelated Debt-Financed Income Tax (UDFI) when applicable rules are followed |
| Requires Form 5498 and an annual valuation of certain assets | Only requires Form 5500 if the plan balance is over $250k |

***Salary Deferral*** - With salary deferral, the account holder can contribute:

- 100% of net earnings/salary from self-employment up to a maximum of $19,500.
- Those who are 50 years old or older qualify for the additional catch-up contribution of $6,500, bringing their salary deferral maximum to $26,000.
- These are the limits for 2020 and 2021.

***Profit-Sharing*** - In addition to salary deferral, the account holder can make a profit-sharing contribution:

- Those set up as an LLC, partnership or sole proprietor can contribute up to 20% of their net earnings from self-employment.
- Those set up as C corporations and S corporations can contribute up to 25% of their salary from self-employment.

***Combined Limit*** - The 2020 contribution limit for the salary deferral and profit-sharing, combined, cannot exceed $57,000 for those under 50 years old or $63,500 for those 50 and over. The 2021 combined limit is $58,000 and $64,500, respectively. Again, this is the maximum amount allowed; the account holder does not have to contribute the full amount.

Since the SEP IRA's annual limit is $57,000 ($58,000 for 2021) as well, it is important to understand the break-even income level when the 20% or 25% profit-sharing contribution will equal $57,000 ($58,000 for 2021) and the salary deferral addition no longer helps to increase the contributable amount.

For 2020, the break-even net income is $285,000 ($290,000 for 2021) for LLCs, partnerships and sole proprietors, and $228,000 ($232,000 for 2021) for C corporations and S corporations. However, if the person is 50 years old or older, the catch-up contribution portion of the salary deferral will increase the limit to $63,500 ($64,500 for 2021). So, for anyone in this age group, the Self-Directed Solo 401(k) would be superior to the SEP IRA from an overall contribution limit standpoint.

Figure 2:

| | 2017 | 2018 | 2019 |
|---|---|---|---|
| Filing Status | Single | Single | Single |
| Number of Exemptions | 1 | N/A | N/A |
| Number of Dependents | N/A | | |
| **Income** | | | |
| Wages, salaries, tips, etc. | 60,793 | 55,305 | 86,420 |
| Taxable interest and dividends | 2,332 | 1,312 | 1,470 |
| Taxable state and local refunds | | | |
| Alimony | | | |
| Business income (loss) | | | 129,404 |
| Gains (losses) | 30,727 | | |
| Pensions and IRA distributions | | | |
| Rent and royalty income (loss) | | | |
| Part, S-corps, trusts income (loss) | 4,195 | (276) | 15,000 |
| Farm income (loss) | | | |
| Unemployment compensation | | | |
| Total SS benefits received | | | |
| Taxable SS benefits | | | |
| Other income (loss) | | | |
| **Total Income** | 98,047 | 56,341 | 232,294 |
| **Adjusted Gross Income** | | | |
| Half of self-employment tax | | | 4,802 |
| IRA deduction | | | |
| Other adjustments | | | |
| **Total Adjusted Gross Income** | 98,047 | 56,341 | 227,492 |

Figure 3:

| | | | |
|---|---|---|---|
| **Deductions** | | | |
| Medical deductions | | | |
| State and local taxes | | | |
| Interest | | | |
| Contributions | | | |
| Employee business expenses | | | |
| Standard or other deductions | 6,350 | 12,000 | 12,200 |
| **Total Itemized or Standard Ded** | 6,350 | 12,000 | 12,200 |
| **Exemption Amount** | 4,050 | N/A | N/A |
| **Qualified Business Income Deduction** | N/A | | |
| **Tax and Credits** | | | |
| **Taxable Income** | 87,647 | 44,341 | 215,292 |
| Tax | 14,350 | 5,607 | 50,252 |
| Credits | | | |
| Self-employment tax | | | 9,604 |
| Other taxes | | | 225 |
| **Total Tax** | 14,350 | 5,607 | 60,081 |
| **Payments** | | | |
| Withholdings | 10,508 | 7,363 | 15,835 |
| Estimated tax payments | | | |
| Earned income credit | | | |
| Other payments and credits | | | |
| **Overpayment** | | 1,756 | |
| Overpayment Applied | | | |
| **Refund** | | 1,756 | |
| **Balance Due** | 3,842 | | 44,246 |
| Marginal tax rate | 25.00 | 22.00 | 35.00 |
| Effective tax rate | 16.40 | 13.00 | 23.34 |

## Case Study: Contribution Effect on Tax Liability and Savings Amount

This is a case study from an actual client, "Michael." He is employed by a company that pays him a base W-2 salary (without qualified plan deductions) along with 1099 commissions that are paid to his LLC. Michael is 26 years old, single with no kids, lives in Texas, and adopted his Self-Directed Solo 401(k) plan in December of 2019. When it came time to prepare Michael's 2019 tax return, his CPA ran the numbers to compare his tax liability if he made no contribution to the plan versus making the maximum contribution

Figure 4:

| | 2017 | 2018 | 2019 |
|---|---|---|---|
| Filing Status | Single | Single | Single |
| Number of Exemptions | 1 | N/A | N/A |
| Number of Dependents | N/A | | |
| **Income** | | | |
| Wages, salaries, tips, etc. | 60,793 | 55,305 | 86,420 |
| Taxable interest and dividends | 2,332 | 1,312 | 1,470 |
| Taxable state and local refunds | | | |
| Alimony | | | |
| Business income (loss) | | | 129,404 |
| Gains (losses) | 30,727 | | |
| Pensions and IRA distributions | | | |
| Rent and royalty income (loss) | | | |
| Part, S-corps, trusts income (loss) | 4,195 | (276) | 15,000 |
| Farm income (loss) | | | |
| Unemployment compensation | | | |
| Total SS benefits received | | | |
| Taxable SS benefits | | | |
| Other income (loss) | | | |
| **Total Income** | 98,047 | 56,341 | 232,294 |
| **Adjusted Gross Income** | | | |
| Half of self-employment tax | | | 4,802 |
| IRA deduction | | | |
| Other adjustments | | | 46,714 |
| **Total Adjusted Gross Income** | 98,047 | 56,341 | 180,778 |

Figure 5:

| | | | |
|---|---|---|---|
| **Deductions** | | | |
| Medical deductions | | | |
| State and local taxes | | | |
| Interest | | | |
| Contributions | | | |
| Employee business expenses | | | |
| Standard or other deductions | 6,350 | 12,000 | 12,200 |
| **Total Itemized or Standard Ded** | 6,350 | 12,000 | 12,200 |
| **Exemption Amount** | 4,050 | N/A | N/A |
| **Qualified Business Income Deduction** | N/A | | 13,076 |
| **Tax and Credits** | | | |
| Taxable Income | 87,647 | 44,341 | 155,502 |
| Tax | 14,350 | 5,607 | ~~31,362~~ |
| Credits | | | |
| Self-employment tax | | | 9,604 |
| Other taxes | | | 169 |
| **Total Tax** | 14,350 | 5,607 | 41,135 |
| **Payments** | | | |
| Withholdings | 10,508 | 7,363 | 15,835 |
| Estimated tax payments | | | |
| Earned income credit | | | |
| Other payments and credits | | | |
| **Overpayment** | | 1,756 | |
| Overpayment Applied | | | |
| **Refund** | | 1,756 | |
| **Balance Due** | 3,842 | | 25,300 |
| Marginal tax rate | 25.00 | 22.00 | 24.00 |
| Effective tax rate | 16.40 | 13.00 | 20.17 |

allowed. Figure 2 is the top portion of Michael's Form 1040 Comparison Table, which shows that he started making 1099 income, in addition to his wages, in 2019.

Since no contribution to his Self-Directed Solo 401(k) is made in this scenario, there is no amount shown on the Other adjustments line, so his AGI is $227,492.

Figure 3 is the bottom portion of Michael's Comparison Table. His Taxable Income shows as being $215,292, with a Balance Due of $44,246. The Marginal tax rate is 35% and the Effective tax rate is 23.34%.

As seen in Figure 4, if Michael does contribute the maximum that he is allowed, the Other adjustments line shows his contribution amount of $46,714 and a reduced AGI of $180,778. As seen in Figure 5, the contribution brought Michael's taxable income down to $155,502 and his tax liability went from being $44,246 to owing only $25,300. His marginal tax rate dropped down two brackets and his effective tax rate is reduced by over 3%. Michael was able to decrease his tax liability by $18,946, which is a 42.8% reduction.

Needless to say, he chose to make the maximum contribution to his plan and is enjoying the tax savings. Michael is also an avid real estate investor, so he can self-direct the $46,714 contribution toward assets that match his preferred investment strategy.

## Additional Contribution Options (If the Plan is Designed to Include Them)

Aside from contributing to a Self-Directed Solo 401(k) with pre-tax dollars, Roth and Voluntary After-Tax contributions can also be made. These options open the door for $57,000 or $63,500 ($58,000 or $64,500 for 2021) depending on age, to be contributed to a Roth account every year, per future limits.

***Roth*** - The salary deferral portion can be contributed after-tax to a designated Roth account, which is not limited to the income cap. For clients who are not particularly concerned about tax savings through deferral today and want to increase their tax-free money in retirement as much as possible, they could make Roth salary deferral contributions along with the pre-tax profit-sharing contributions.

They would then convert the profit-sharing contribution to the Roth account and pay the tax on it. From there, the client can invest all of the funds through their Roth account so that the basis, income and gain will all be tax free upon withdrawal.

***Voluntary After-Tax*** - 100% of net income from self-employment, up to the annual limit, can be contributed

after-tax. Since the income and gain on after-tax contributions is taxable upon withdrawal, the client will want to convert the money to the Roth account right away and report it with information from Form 1099-R. The strategy of contributing voluntary after-tax funds and then converting them to a Roth account is commonly referred to as a Mega Backdoor Roth.

Contributing after-tax dollars is also a way to maximize, and reach, the contribution limit amount of $57,000 or $63,500 ($58,000 or $64,500 for 2021) since it can be made in addition to the salary deferral and profit-sharing contributions.

For example, look at Michael's case study again. He could only contribute $46,714 because of his income level. If Michael wanted to max out the full contribution amount allowed, he could have added an additional $9,286 of after-tax dollars to reach the 2019 limit of $56,000.

## Timing and Methods for Contributing to the Plan

The salary deferral and profit-sharing contributions can be made in any amount and at any time, per applicable limits, deadlines and payroll schedules. This means that the account holder can make contributions on any schedule that works for them, such as bi-monthly, monthly, quarterly, annually or at random. It is not mandatory to make contributions; they can be missed here and there, or not made at all. There is no minimum amount required when making a contribution and the amount can be changed as needed.

After the initial contribution to make the plan effective, which should happen within a couple months of the plan adoption, future contributions do not have to be made if the account holder chooses not to, for whatever reason. That said, the account holder will want to make at least a small contribution every few years so that it does not appear to the IRS that the plan is no longer active and thus no longer valid.

In addition to funding the account with salary deferral, profit-sharing and voluntary after-tax contributions, the account holder can roll their current retirement account(s), in part or in whole, into the plan to increase the asset class diversification potential. Any pre-tax account can be used, such as IRAs, SEP IRAs, old 401(k)s, etc., but no pre-existing Roth, after-tax or HSA account can be rolled into the plan. Information from Form 1099-R will need to be used to report the rollover on Form 1040 for the tax year that the rollover took place.

**Those who are 50 years old or older qualify for the additional catch-up contribution of $6,500...**

## Loan Feature (If the Plan is Designed to Include It)

One of the best provisions found in Self-Directed Solo 401(k) plans is the loan feature. This allows the account holder the ability to borrow up to $50,000 or 50% of the balance in the account, whichever is less, tax and penalty free. The money can be used for anything without restriction. Multiple loans can be taken out at any time so long as the combined amount does not exceed the limit and the applicable rules are followed.

Generally, the repayment period is five years, but if it is used for the purchase of a primary residence, the account holder has 15 years to pay it back. Interest is owed on the loan, typically prime plus 1%, but the interest goes back into the 401(k) account and added to the retirement funds, as opposed to it going to a financial institution, which would be the case with a typical loan. Payments must be made no less than quarterly. Any amount not repaid from a loan (after grace periods are exhausted) will be considered a distribution and any applicable taxes and penalties will be due by the account holder.

The Self-Directed Solo 401(k) essentially becomes the account holder's personal bank that will lend money without an application or underwriting. They can borrow from the plan, instead of being in debt to another institution or person. Also, business owners who use a loan to fund their business can expense the interest they are paying back to the account and treat it the same as if they were paying interest to a bank for a business loan.

## Investment Options for Self-Directed Solo 401(k)s

**Assets that it can invest in.** Another great advantage to the Self-Directed Solo 401(k) is that the account holder can self-direct the funds to be invested in almost any asset class, including, but not limited to:

- Residential and commercial real estate;
- Tax liens, deeds and foreclosures;
- Land;
- Oil and gas mineral rights;
- The stock market, funds, bonds, futures and options;
- Most business types;
- Private and hard money loans;
- Select precious metals and some coins.

Disqualified Person and Prohibited Transaction rules apply when engaging in any investment transaction.

**Assets that it cannot invest in.** The simpler list to provide consists of the

assets disallowed from investment. The one business type that it cannot invest in/be an owner of is an S corporation because the Self-Directed Solo 401(k) cannot be a shareholder of a business. It also cannot invest in art, collectibles such as stamps and baseball cards, or life insurance contracts.

## Plan Adoption and Contribution Deadlines

For 2019 and prior years, the Self-Directed Solo 401k plan had to be established by the end of the tax year. The SECURE Act changed this deadline. Starting with the 2020 tax year, business owners can establish a Self-Directed Solo 401(k) plan up until the tax filing deadline, plus extension, for the preceding year.

Contribution deadlines depend on how the business entity is taxed and the type of contribution being made. For LLCs, partnerships and sole proprietors, salary deferral and profit-sharing contributions can be made up until the personal tax filing deadline, plus extension. For C corporations and S corporations, the salary deferral portion must be contributed as the salary to be contributed is earned, within at least seven days, and generally through payroll deductions. Profit-sharing contributions can be made up until the corporate tax filing deadline, plus extension.

## Independent Firms That are Self-Directed Solo 401(k) Plan Providers

Opening a Self-Directed Solo 401(k) retirement plan is a little different than a regular Solo 401(k) or IRA-type plan. Regular Solo 401(k)s, and other qualified retirement plans like SEP IRAs can be opened at a number of financial institutions that offer retirement plans. Major financial institutions do not typically offer plans for Self-Directed Solo 401(k)s, however, since they act as custodians and the money can get moved away from the products that they sell, such as stocks and mutual funds.

Self-directed funds are also managed by the account holder, as trustee, and do not require a custodian. An independent Self-Directed Solo 401(k) plan provider is able to facilitate and provide this type of plan and give ongoing education and guidance to the account holder, and their CPA/tax preparer, if needed.

## Icing on the Cake

Not everyone can afford to shave off a large portion of their net income to maximize their contribution amount, but the Self-Directed Solo 401(k) gives them the option, and the ability, to contribute more than just the profit-sharing limit that the SEP IRA allows. The high contribution limit can make a big difference to a business owner's tax liability and it could possibly bring them down to a lower tax bracket, especially for those with higher incomes. It could also help offset other tax liabilities due to a lack of tax-savings options if, for example, the person's spouse has a high-paying W-2 job.

The increased flexibility and self-direction that the Self-Directed Solo 401(k) plan affords is like the icing on the Solo 401(k) cake. For any qualifying client who wants to maximize their contribution options and amounts, maximize tax efficiencies today and/or in retirement, and have direct control over a diversified and personalized investment portfolio, this option checks off more boxes than any other employer-sponsored plan.

**ABOUT THE AUTHOR:**
Whitney Nash, CPFA, the President and CEO of Nashional Self-Directed LLC, is a Self-Directed Solo 401(k) plan provider and educational consultant in McKinney, TX. She may be contacted at whitney@nashionalsd.com.

**ATTRIBUTION:**
Neal, Richard E. "Text - H.R.1994 - 116th Congress (2019-2020): *Setting Every Community Up for Retirement Enhancement Act of 2019*." **Congress.gov**, 3 June 2019, https://bit.ly/3esPyft


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# Understanding and Avoiding Auditing-related Enforcement Actions

By Abdullah al-Moshaigeh, Ph.D., Denise Dickins, Ph.D., CPA, CIA, and Julia L. Higgs, Ph.D., CPA

**CURRICULUM:** Accounting and Auditing

**LEVEL:** Basic

**DESIGNED FOR:** Auditors and CPAs in public practice

**OBJECTIVES:** To describe the interrelationship between the enforcement processes of the Public Company Accounting Oversight Board (PCAOB), the American Institute of CPAs (AICPA) and state boards of accountancy (BOAs), and help CPAs better understand and avoid auditing-related enforcement actions

**KEY TOPICS:** PCAOB, AICPA and BOA enforcement issues, present data of recent actions, the interrelationship of auditing-related enforcement actions and adhering to the professional standards

**PREREQUISITES:** None

**ADVANCED PREPARATION:** None

In the United States, CPAs who perform audits are obligated to follow many rules and regulations, including those of the Public Company Accounting Oversight Board (PCAOB), the American Institute of CPAs (AICPA) and state boards of accountancy (BOAs). To help CPAs better understand and avoid auditing-related enforcement actions, in this article we describe the interrelationship between the enforcement processes of these organizations and present data of recent enforcement actions.

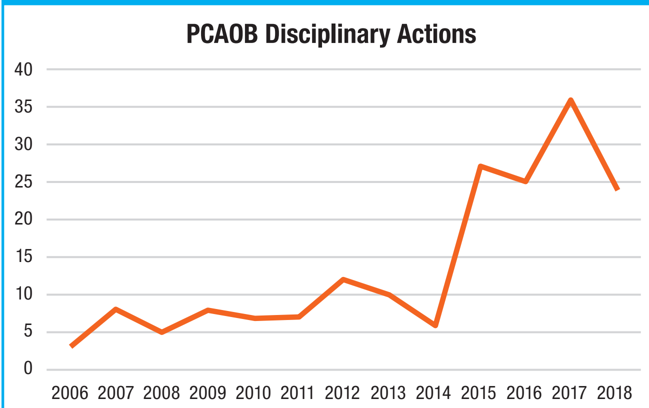
## PCAOB Enforcement

PCAOB has authority to investigate and discipline registered public accounting firms and persons associated with those firms for noncompliance with its rules, other laws and rules, and professional standards governing the audits of issuers and broker-dealers. Investigations can be initiated based on the results of its annual or triennial inspections of registered CPA firms, confidential tips or its interactions with CPAs of registered firms. PCAOB's Division of Enforcement and Investigations conducts enforcement activities.

Cases unrelated to issuer audits, such as insider trading by a CPA, are handled by the Securities and Exchange Commission (SEC) and the Department of Justice (DOJ). This article does not address these types of matters.

As depicted in Figure 1, from the date PCAOB issued its first enforcement report on May 24, 2005, through December 31, 2018, 183 U.S. CPAs were sanctioned.

**Figure 1: PCAOB Disciplinary Actions by Year**




Source: Compilation of data available at https://pcaobus.org/enforcement/Pages/default.aspx.

**Table 1.**
**PCAOB Infractions (May 24, 2005 to May 31, 2018).**

| Infraction | Frequency |
|---|---|
| Lack of skepticism or due care | 23% |
| Poor quality control | 16 |
| Poor documentation | 13 |
| Altered or misleading documentation | 9 |
| Lack of independence | 9 |
| Lack of cooperation | 9 |
| Other | 21 |
| Total | 100% |

> **The CPC requires that members "act in a way that will serve the public interest, honor the public trust and demonstrate a commitment to professionalism."**

Prior to 2012, sanctions averaged six per year, then increased dramatically. This increase may be related to the appointment of James Doty as chairman of PCAOB in 2011 and his announcement of an increased emphasis on enforcement actions.

Doty was replaced on December 12, 2017 by William D. Duhnke III, and most other members of the PCAOB board were replaced in 2018. Like other organizations with political appointees, regime changes likely impact their regulatory and enforcement activities.

PCAOB can charge CPAs with a variety of infractions, including:

- Lack of independence,
- Inadequate documentation,
- Failing to adhere to auditing standards,
- Lack of skepticism or due care,
- Altering documentation, or
- Failing to cooperate with inspectors, among others.

As summarized in Table 1, for PCAOB enforcement actions occurring through May 31, 2018, the most frequently cited infraction was lack of skepticism or due care (23%). Also highly cited were poor quality control, including related to engagement quality reviews (16%), poor documentation (13%), altered or misleading documentation (9%), lack of independence (9%) and lack of cooperation (9%).

Associated disciplinary actions range from censure (a warning that repeat behavior will be punished), to revocation of the CPA's firm registration (preventing future audits of issuers). Examples of the activities and their resulting disciplinary actions are provided in Table 2.

Our analyses of enforcement actions through December 31, 2018 reveal that most commonly, they result in revoking the registration of the CPA's firm (74%) and the infraction associated with the most severe disciplinary action is altering documentation. When assessed against individual CPAs, fines associated with enforcement actions average $6,485 and range from zero to $100,000. When assessed at the firm level, fines have reached $2,000,000 (against EY in the Medicis audit).

## BOA Enforcement

While PCAOB can assess fines and prevent CPAs from performing issuer audits, it cannot prevent a CPA from practicing public accounting. The practice of public accounting is regulated and governed by state BOAs. CPAs prohibited from performing issuer audits can still engage in tax services, non-attest services and audits of non-issuers.

BOAs establish rules concerning professional competence, the exercise of due care, and adequate planning and performing attest and non-attest services. Most BOAs require that CPAs complete an annual or bi-annual minimum number of continuing professional education (CPE) hours and participate in periodic peer reviews. Failure to abide by the rules can result in censure, fines and/or license revocation.

BOAs are made aware of auditing-related issues through a variety of sources, including notification by PCAOB (or other federal and state agencies), complaints or licensee self-reporting. Most BOAs require CPAs to report within 30 days any conviction or judgment by other enforcement organizations, as well as results of administrative proceedings.

Although peer reviews may detect violations of BOA rules, because their effectiveness is dependent upon mutual trust between reviewees and reviewers, disciplinary actions are only pursued when reviewees fail to cooperate or correct identified deficiencies.

Investigations are typically resolved in less than one year. Based on our interviews with several BOA members, the severity of imposed sanctions depends on the severity of the infraction, but also may consider the age of the case and the severity of sanctions imposed by other organizations. BOA actions against CPAs are typically public and are available at each BOA's website. The National Association of State Boards of Accountancy (NASBA) provides links to each of their member BOAs (see: https://nasba.org/stateboards/).

**Table 2.**
**Example Activities Sanctioned by PCAOB.**

| Activity | Disciplinary Action |
|---|---|
| Numerous and repeated violations of PCAOB rules and auditing standards in auditing the financial statements of three issuers. | Revocation of registration of the CPA's firm |
| Alteration of documents prior to inspection and failure to cooperate in the inspection. | Censuring, barring and 40 hours of continuing professional education (CPE) |
| Failure to properly assess the risk of material misstatement, to properly evaluate and use a specialist, to sufficiently test revenue, and to communicate with the audit committee. | Censure, suspend for one year, limiting activities, and CPE |
| Failure to comply with cooling-off requirements of Auditing Standard No. 7, *Engagement Quality Reviews*. | Censure and fine |
| Failure to perform or ensure the performance of adequate audit procedures on material accounts and failure to properly supervise engagement team personnel. | Censure and CPE |

## AICPA Enforcement

AICPA has established a Code of Professional Conduct (CPC) with which its members must abide. The CPC covers three types of members: those in public practice, industry, and retired or otherwise unemployed. As most recently amended on Dec. 15, 2014, the CPC requires that members "act in a way that will serve the public interest, honor the public trust, and demonstrate a commitment to professionalism." Members do this by, among other things, discharging their responsibilities with integrity, objectivity (and independence when required, as when performing an attest engagement), and using due professional care.

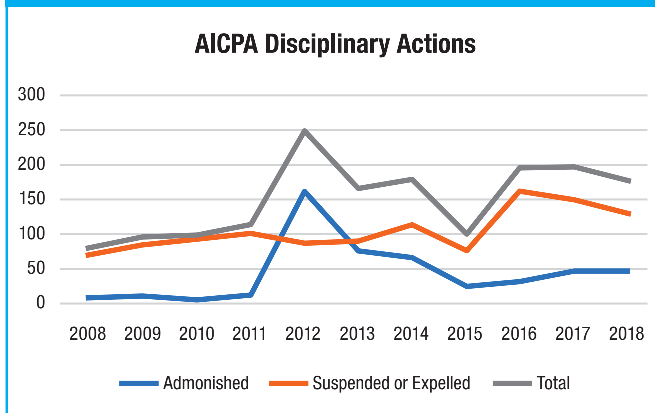
Compliance with the CPC is primarily monitored through notices from other organizations, such as BOAs, state CPA societies, PCAOB and the Internal Revenue Service (IRS), or by reports received directly by mail or email at: ProfessionalEthicsSubmissions@aicpa.org. Although membership in AICPA is voluntary, many CPAs participate in its peer review coordination program and application tool to help, among other things, meet the peer review requirement of state BOAs (PRIMA – see: https://www.aicpa.org/interestareas/peerreview.html). When CPA firms enrolled in the peer review program fail to cooperate or remediate identified deficiencies, membership in the program is terminated.

Firm terminations are posted on AICPA's website (see: https://www.aicpa.org/forthepublic/prfirmterm.html). In 2018, AICPA terminated the memberships of 26 firms; and in 2017, 2016 and 2015, firm memberships totaling 25, 34 and 21, respectively, were terminated.

Responsibility for enforcement actions is delegated to AICPA's Professional Ethics Executive Committee (PEEC). Disciplinary actions imposed are admonishment (public reprimand), suspension or termination of membership. Most disciplinary actions are the result of enforcement activities of "approved entities" (e.g., PCAOB, BOAs, SEC, IRS).

As needed, the PEEC conducts joint investigations with state CPA societies (the Joint Ethics Enforcement Program - JEEP). It can also conduct independent investigations of violation reports of the CPC. The results of investigations

**Figure 2: AICPA Disciplinary Actions by Year**




Source: Annual reports of the AICPA Professional Ethics Division disciplinary activity. Available at: https://www.aicpa.org/interestareas/professionalethics/resources/ethicsenforcement.html

**CPE courses covering a range of topics to stay current in this area can be found in the Education section of TXCPA's website at www.tx.cpa.**

are only made public if a member is found to have violated the CPC or if a settlement agreement involves membership rights and the member agrees to publication.

Although the details of CPA disciplinary actions are available on AICPA's website (https://www.aicpa.org/forthepublic/disciplinaryactions.html), they are routinely removed in accordance with the following guidelines:

- One year following admonishment,
- One year after a suspension period,
- A maximum of seven years after termination.

Of the 454 disciplinary actions reported on AICPA's website as of May 30, 2019, 328 were automatic disciplinary actions, 47 were the result of settlements with the JEEP and 79 were matters decided by the AICPA Joint Trial Board. Importantly, these actions are the result of more than auditing-related issues.

As depicted in Figure 2, AICPA enforcement actions against CPAs during the period from 2008 to 2018 totaled 1,651, ranged from 80 (2008) to 249 (2012), and averaged 150 each year. In 2012, AICPA initiated a record number of cases (n = 768, not tabulated), which resulted in a record number of admonishments (n = 161) and a record number of corrective actions (n = 244, not tabulated), although the reason is unclear.

Of the AICPA enforcement actions during the years 2005 to 2014, 47% were due to substandard professional practice, 28% were associated with criminal actions, 18% were related to failures to cooperate in an investigation or to comply with a directive, and 7% were for other matters (see: Armitage, J. L., and Moriarity, S. R., "An examination of AICPA disciplinary actions: 1980–2014," *Current Issues in Auditing*, 10, 2, 2016, A1-A13). Penalties associated with substandard work became more stringent during the period from 1980 to 2014.

## The Interrelationship of Enforcement Actions

Table 3 provides examples of the interrelationship of auditing-related enforcement actions. The comparisons represent five automatic disciplinary actions of AICPA related to matters reported by PCAOB or the SEC.

Evident from the data is how AICPA-automatic actions align with the terms of PCAOB or SEC discipline; membership suspensions mirror the time period preceding a CPA's right to apply for reinstatement to practice before PCAOB and the SEC. Also evident is the variation in enforcement actions of BOAs, which is likely due to variation in the structure and resources of state BOAs.

## Avoiding Enforcement

Obviously, the best way to avoid enforcement is to adhere to the professional standards. Many firms faced PCAOB sanctions related to engagement quality review issues that may have been avoided by greater understanding and diligence in execution when AS 1220, *Engagement Quality Reviews*, was enacted in 2009.

CPE courses are required to ensure that practitioners stay current. Courses cover a range of topics from the implementation of new standards, to exercising professional skepticism. Practitioners should diligently select courses relevant to their practice area and be attentive during the courses.

There are also opportunities to interact with auditing standard setters. For example, PCAOB regularly holds roundtables around the country for practitioners to learn about areas that are important at the inspection and enforcement level.

Each year, PCAOB, BOAs and AICPA take action against CPAs for revising documentation and non-cooperation. While CPAs may fear that their work was deficient,

**Table 3.**
**Comparison of Enforcement Actions.**

| Effective Date of AICPA Action | Violation | PCAOB or SEC Action | BOA Action (state) | AICPA Action |
|---|---|---|---|---|
| 23-Feb-17 | Failed to obtain sufficient appropriate audit evidence to address identified fraud risks, to adequately document critical aspects of the audit and to adequately supervise the audit. | Barred from being associated with a registered public accounting firm with the right to apply for reinstatement after two years | $1,150 fine and 26 hours of CPE (CO) | Membership suspended for two years |
| 20-Mar-17 | Violation of Rule 3502, *Responsibility Not to Knowingly or Recklessly Contribute to Violations* that contributed to violations of auditing standards pertaining to engagement quality reviews and reporting of illegal acts. | Barred from being associated with a registered public accounting firm with the right to apply for reinstatement after three years | License suspended for three years; CPE; $1,500 fine (WA) | Membership suspended for three years |
| 24-Oct-14 | Attempted to circumvent the auditor rotation requirement. | Barred from practicing before the SEC with the right to apply for reinstatement after one year | Probation for one year (FL) | Membership suspended for one year |

there are rules that prohibit altering or removing documentation from the auditor's working papers.

Altering working papers more than 45 days after release of the auditor's opinion on an issuer (AS 1215) or more than 60 days after the release for a non-issuer (AU-C 230) virtually guarantees an enforcement action, while inspection or peer review outcomes on questions about audit judgments are less certain.

As described by former associate director in the Division of Enforcement and Investigations of PCAOB, Rob Berger: "In most cases, the alteration of audit documentation was the most severe violation, far worse than any audit failure. As they say, the cover-up is worse than the crime" (Berger, R., "How the PCAOB uncovers altered work papers," ***Accounting Web***, 2016, available at: https://www.accountingweb.com/aa/auditing/how-the-pcaob-uncovers-altered-work-papers).

The likelihood of violating these rules could be reduced by implementing automated controls that prevent modification of electronic work papers without specific approvals. Enforcement organizations are likely more lenient when CPAs cooperate and are penitent.

## ABOUT THE AUTHORS:

*Abdullah al-Moshaigeh, Ph.D., is an Adjunct Professor at Florida Atlantic University, where he teaches financial and managerial accounting. His research interests include corporate governance, big data analytics and internal auditing.*

*Denise Dickins, Ph.D., CPA, CIA, is a Professor at East Carolina University. Her teaching and research interests include auditing and corporate governance. Contact her at DICKINSD@ecu.edu.*

*Julia L. Higgs, Ph.D., CPA, is a Professor at Florida Atlantic University, where she teaches auditing and financial accounting. She has published in academic and professional journals on numerous topics relevant to the accounting profession.*

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

# CPE ARTICLE: UNDERSTANDING AND AVOIDING AUDITING-RELATED ENFORCEMENT ACTIONS

By Abdullah al-Moshaigeh, Ph.D., Denise Dickins, Ph.D., CPA, CIA, and Julia L. Higgs, Ph.D., CPA

*Today's CPA* offers the self-study exam for readers to earn one hour of continuing professional education credit. The questions are based on technical information from the preceding article. If you score 70 or better, you will receive a certificate verifying you have earned one hour of CPE credit – granted as of the date the test arrived in the TXCPA office – in accordance with the rules of the Texas State Board of Public Accountancy (TSBPA). If you score below 70, you will receive a letter with your grade.

**1. The rules of which of these organizations are auditors of U.S. issuers *not* required to follow:**
a. Public Company Accounting Oversight Board (PCAOB)
b. International Auditing and Assurance Standards Board
c. American Institute of Certified Public Accountants (AICPA)
d. State Boards of Accountancy (BOAs)

**2. Which of these is *not* a way investigations can be initiated by PCAOB?**
a. Nonpayment of state sales taxes
b. Inspections of registered CPA firms
c. Confidential tips
d. Interactions with CPAs of registered firms

**3. Which of these is an organization that investigates matters like insider trading by CPAs?**
a. PCAOB
b. Securities and Exchange Commission
c. State Boards of Accountancy
d. Federal Bureau of Investigation

**4. The most frequently cited infraction charged CPAs by PCAOB (through mid-2018) was:**
a. Poor documentation
b. Failing to cooperate with inspectors
c. Lack of independence
d. Lack of skepticism or due care

**5. The AICPA Code of Professional Conduct covers members in public practice, industry, and retired or otherwise unemployed.**
a. True
b. False

**6. Which of these may not be the result of an investigation conducted by PCAOB?**
a. CPA license revocation
b. Revocation of the CPA firm's registration
c. CPA firm fine
d. CPA fine

**7. CPAs prohibited from performing issuer audits can still engage in all of the following *except*:**
a. Tax services
b. Non-attest services
c. Audits of benefit plans of issuers
d. Audits of non-issuers

**8. Failure to abide by the rules of State BOAs can result in all but:**
a. Censure
b. Incarceration
c. Fines
d. License revocation

**9. Compliance with the AICPA Code of Professional Conduct is monitored primarily through notices from other organizations such as all of these, *except*:**
a. BOAs
b. Internal Revenue Service
c. PCAOB
d. Government Accountability Office

**10. Which of these is *not* a way a CPA can reduce the likelihood of audit-related enforcement actions?**
a. Participate in continuing professional education that includes accounting, auditing and quality control topics
b. Implement automated controls that prevent the modification of electronic working papers
c. Participate in continuing professional education that includes state and federal income tax topics
d. Cooperate with enforcement organizations

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$1,078,687 gross. Heart of Texas CPA firm. 83% tax (65% individuals, 30% business, 5% other), 11% accounting, 5% audits, 1% other, cash flow 45%. TXC1077

$445,000 gross. Heart of Texas CPA firm. 80% tax (78% inv., 13% bus., 9% other), 11% bkkpng, 9% audits/reviews, cash flow around 43%, staff in place, owner available to stay on as employee after sale if needed. TXC1078

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

$209,000 gross. NE Texas CPA firm. 70% tax, 30% acctng, ideal size for marketing-oriented buyer to tap existing client base and grow substantially. TXN1491

$608,000 gross. SW of Ft. Worth CPA firm. Accntng (15%), tax (75%), payroll/compliance/misc. (10%), great location, quality clients, dedicated staff. TXN1534

$40,000 gross. SE Dallas tax and bookkeeping firm. Primarily tax 81%, though accounting is done for several businesses as well, turn-key starter practice or easy add on. TXN1537

$310,000 gross. SE Texas CPA firm. Tax 60%, bkkpg 40%, turn-key practice with staff in place, friendly clients, owner available to assist through tax season. TXS1232

$1,125,000 gross. N. Houston CPA firm. Tax 66%, audit/reviews 22%, bkkpng 12%, excellent cash flow, long-term premium client base, staff in place, key location available. TXS1246

$408,000 gross. NW Houston CPA firm. Available after 4/15/21. Bkkpng 42%, tax 35%, consulting and tax planning 50%, can be operated from any Houston-based location. TXS1255

$1,209,000 gross. West Houston CPA firm. Tax 53%, bkkpng. 38%, audit/reviews 9%, prime location, excellent cash flow, loyal client base, experienced staff in place, turn-key. TXS1262

$1,555,000 gross. Gulf Coast area CPA firm. Audits 40%, tax 32%, bkkpng 19%, misc. 9%, knowledgeable staff in place, long-term and loyal client base, office available. TXS1263

$1,700,000 gross. N. Houston CPA firm. Great mix of services including tax, bookkeeping and consulting, strong staff in place, owner available for transition, turn-key but could be moved to any Houston-based location. TXS1264

$2,441,388 gross. West TX CPA firm. 80% tax (42% individual, 40% business, 18% other), 20% bkkpng, payroll and limited consulting engagements, cash flow over 60%, turn-key practice with staff in place and one partner open to staying on long term. TXW1026

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