Critical Issues That CPAs in Industry Will Need to Face This Year

CII4/26/V1

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Learning Objective

- Understand the impacts of major tax legislation and recent accounting pronouncements on CPAs in industry

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Course Overview

- Chapter 1 – FASB Update
- Chapter 2 – Compensation for Passthrough Entity Owners
- Chapter 3 – Miscellaneous Business Considerations
- Chapter 4 – Stage 3 – The Final PIR Process for ASC Topic 842, *Leases*

A Quick Word on Policy vs. Politics

- Many times when discussing accounting, tax and financial policy issues, it can be difficult to divorce the politics from the policy
- Today, when discussing the various issues we will encounter over the next several hours, let's agree to keep our own view of politics out of the application of the policy and focus on doing the very best we can for all our clients
- This goes for religious/faith views as well

Chapter 1

FASB Update

Learning Objectives

- After completing this chapter, you should be familiar with:
  - Recently issued ASUs of greatest significance to smaller and medium-sized entities;
  - Recently issued ASUs impacting SEC registrants and other public entities; and
  - Items on the FASB’s technical agenda

Recently Issued Accounting Standards Updates

- ASU No. 2026-01, *Equity (Topic 505): Initial Measurement of Paid-in-Kind Dividends on Equity-Classified Preferred Stock*
  - Provided authoritative guidance for the initial measurement of paid-in-kind (PIK) dividends on equity-classified preferred stock
- ASU No. 2026-02, *Environmental Credits and Environmental Credit Obligations (Topic 818)*
  - Established a comprehensive recognition, measurement, presentation, and disclosure framework for environmental credits and environmental credit obligation liabilities

ASU No. 2026-02, *Environmental Credits and Environmental Credit Obligations (Topic 818)*

- Creates an entirely new Topic (Topic 818) to address the accounting for environmental credits and environmental credit obligations, including carbon offsets
- Establishes a comprehensive recognition, measurement, presentation, and disclosure framework for environmental credits such as emissions allowances, renewable identification numbers (RINs), renewable energy certificates (RECs), and carbon offsets
- It also creates a dedicated model for obligations arising from regulatory compliance programs

ASU No. 2026-02 – Reason for Issuance

- Environmental markets have expanded dramatically over the last two decades. Entities increasingly participate in cap-and-trade systems, renewable fuel standards, renewable portfolio standards, and voluntary carbon reduction programs
  - Despite this growth, GAAP contained no dedicated accounting framework for these arrangements
- As a result, companies often analogized the accounting to inventory accounting, intangible asset accounting, or contingency guidance, producing inconsistent recognition and measurement outcomes

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ASU No. 2026-02 – Main Provisions (ECs)

- **Environmental credit:** “enforceable rights represented to prevent, control, reduce, or remove emissions or other pollution that are separately transferable in an exchange transaction.” Examples include emissions allowances, renewable energy certificates, renewable identification numbers, and carbon offsets
- Environmental credits are recognized as assets only when it is probable that they will be:
  a. Used to settle an environmental credit obligation;
  b. Transferred in an exchange transaction; or
  c. Used in a nonreciprocal transfer
- Credits acquired solely for voluntary sustainability initiatives, such as voluntary net-zero commitments, generally are expensed as incurred rather than recognized as assets

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ASU No. 2026-02 – Main Provisions (ECs)

- The Update creates two categories:
  - **Compliance environmental credits** – Credits expected to be used to satisfy regulatory obligations. These remain recorded at cost and are not subsequently remeasured
  - **Noncompliance environmental credits** – All other credits held for other purposes, such as trading. These are measured at cost less impairment and must be tested for impairment each reporting period. The credit is impaired if carrying value exceeds fair value. Impairment reversals are prohibited
- Entities may elect a fair value option for certain eligible classes of noncompliance credits, with changes recognized in earnings. Entities are required to present compliance environmental credit assets separately from environmental credit obligation liabilities on the balance sheet (e.g., no offsetting)

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ASU No. 2026-02 – Main Provisions (ECOs)

- An environmental credit obligation (ECO) is defined as “enforceable obligations resulting from regulatory compliance programs represented to prevent, control, reduce, or remove emissions or other pollution that may be settled with environmental credits”
- An obligation is recognized when emissions or other qualifying events occur that create a compliance requirement
  - Voluntary environmental commitments do not create environmental credit obligations under Topic 818

ASU No. 2026-02 – Main Provisions (ECOs)

- The entity must measure the ECO "using the carrying amount of the compliance environmental credits that the entity holds and expects to use to settle that obligation at the reporting date"
  - This is referred to as the funded portion of the ECO
- If the entity lacks sufficient credits to satisfy the liability, the unfunded portion must be "measured at the fair value of the environmental credits necessary to settle the unfunded portion at the reporting date, with certain exceptions"
- The ECO should be derecognized when an entity remits the necessary environmental credits to a regulator

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ASU No. 2026-02 – Presentation and Disclosure

- Disclosure requirements for ECs:
  - The entity must disclose qualitative information about how it obtains and intends to use such credits. The entity must also disclose the current and noncurrent portions of the credits, total impairment expense, and total expenses for voluntary environmental credits
  - For annual reporting periods, if the use or intended use of environmental credits changes, the company must disclose:
    a. The nature of the change as of the date it occurs; and
    b. The impact on earnings

ASU No. 2026-02 – Presentation and Disclosure

- For ECOs, for annual periods, the entity must disclose the following:
  - The activities or events that result in environmental credit obligation liabilities under those programs, including the nature and timing of settlement provisions;
  - The accounting policies used to account for the environmental credit obligations;
  - How the unfunded portion of an environmental credit obligation liability is measured;
  - Significant estimates and judgments used in applying the guidance;
  - The current and noncurrent amounts of the funded and unfunded portions of environmental credit obligation liabilities (if not separately presented on a classified balance sheet);
  - Total expense related to environmental credit obligation liabilities; and
  - Total costs associated with environmental credit obligation liabilities that are capitalized in the carrying amount of another asset during the reporting period in accordance with another Topic

ASU No. 2026-02 – Effective Date and Transition

- The ASU applies to all entities
- For public business entities, the Update is effective for annual periods beginning after December 15, 2027, including interim periods. For all other entities, the effective date is December 15, 2028
  - Early adoption is permitted as of the beginning of an annual reporting period
- The standard is adopted using a **retrospective approach** through a cumulative-effect adjustment to opening retained earnings
  - Prior periods are not restated
- At adoption, entities must reassess existing environmental credits and obligations under the new framework, including derecognizing certain voluntary environmental credits that no longer qualify for asset recognition and recognizing EC assets if it's probable the entity will use ECs to settle an ECO, transfer the credit in an exchange transaction, or use the credit in a nonreciprocal transfer

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ASU No. 2026-01, *Equity (Topic 505): Initial Measurement of Paid-in-Kind Dividends on Equity-Classified Preferred Stock*

- Establishes authoritative guidance for the initial measurement of paid-in-kind (PIK) dividends on equity-classified preferred stock. Prior to this Update, U.S. GAAP addressed when PIK dividends should be recognized but did not provide explicit guidance regarding how they should be measured
  - As a result, issuers used varying approaches, including fair value measurement and measurement based on contractual dividend rates, creating diversity in practice and reducing comparability across financial statements
- The Update resolves this issue by requiring issuers to measure PIK dividends based on the dividend rate specified in the preferred stock agreement

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ASU No. 2026-01 – Main Provisions

- The core provision requires that PIK dividends on equity-classified preferred stock be initially measured using the PIK dividend rate specified in the preferred stock agreement
  - For example, if the agreement specifies that dividends equal a stated percentage multiplied by the liquidation value of the preferred stock, the dividend is measured using that formula
    - Consider a preferred stock instrument with a liquidation value of $10 million and a contractual PIK dividend rate of 8 percent. Under the new guidance, the issuer would recognize a PIK dividend of $800,000 ($10M x 8 percent) based on the contractual formula
- The Update defines PIK dividends as dividends satisfied either by issuing additional preferred shares with terms identical to the original instrument or by increasing the value of the existing preferred stock, such as increasing the original's liquidation value
- Unlike fair value approaches, it does not require recurring valuation exercises or subjective judgments regarding market pricing

ASU No. 2026-01 – Effective Date and Transition

- The amendments are effective for all entities that issue PIK dividends on equity-classified preferred stock for annual reporting periods beginning after December 15, 2026, including interim periods within those years
  - Early adoption is permitted
- Entities may choose either:
  - **Prospective application**, applying the new guidance to PIK dividends recognized after adoption; or
  - **Modified retrospective application**, applying the guidance to equity-classified preferred stock instruments that are outstanding as of the initial application date

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Recently Issued Accounting Standards Updates

- ASU No. 2025-01, *Income Statement – Reporting Comprehensive Income – Expense Disaggregation Disclosures (Subtopic 220-40): Clarifying the Effective Date*
  - Clarified the effective date for ASU No. 2024-03
- ASU No. 2025-02, *Liabilities (Topic 405): Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 122*
  - Removed guidance from SAB 121 that was repealed by SAB 122
- ASU No. 2025-03, *Business Combinations (Topic 805) and Consolidation (Topic 810): Determining the Accounting Acquirer in the Acquisition of a Variable Interest Entity*
  - Clarified how to identify the accounting acquirer when a VIE is involved in an acquisition

Recently Issued Accounting Standards Updates

- ASU No. 2025-04, *Compensation – Stock Compensation (Topic 718) and Revenue from Contracts with Customers (Topic 606): Clarifications to Share-Based Consideration Payable to a Customer*
  - Clarified the accounting for share-based consideration payable to a customer in a revenue contract
- ASU No. 2025-05, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses for Accounts Receivable and Contract Assets*
  - Simplified the application of CECL for trade receivables and contract assets
- ASU No. 2025-06, *Intangibles – Goodwill and Other – Internal-Use Software (Subtopic 350-40): Targeted Improvements to the Accounting for Internal-Use Software*
  - Modernized guidance for capitalizing internal-use software costs, including agile development environments

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Recently Issued Accounting Standards Updates

- ASU No. 2025-07, *Derivatives and Hedging (Topic 815) and Revenue from Contracts with Customers (Topic 606): Derivatives Scope Refinements and Scope Clarification for Share-Based Noncash Consideration from a Customer in a Revenue Contract*
  - Refined derivative scope exceptions and clarified revenue guidance related to noncash consideration
- ASU No. 2025-08, *Financial Instruments – Credit Losses (Topic 326): Purchased Loans*
  - Clarified the accounting for purchased loans under the CECL model
- ASU No. 2025-09, *Derivatives and Hedging (Topic 815): Hedge Accounting Improvements*
  - Improved hedge accounting to better reflect an entity’s risk management activities
- ASU No. 2025-10, *Government Grants (Topic 832): Accounting for Government Grants Received by Business Entities*
  - Established accounting guidance for government grants received by business entities

Recently Issued Accounting Standards Updates

- ASU No. 2025-11, *Interim Reporting (Topic 270): Narrow-Scope Improvements*
  - Clarified and improved interim reporting disclosure requirements
- ASU No. 2025-12, *Codification Improvements*
  - Minor in scope – Made technical corrections and clarifications across multiple areas of the Codification
    - Not covered in this course – minor scope and impact

ASU No. 2025-11, *Interim Reporting (Topic 270)*

- ASU 2025-11 reorganizes Topic 270 to present a clearer, more coherent framework for interim disclosures. The Update clarifies what must be disclosed in condensed interim financial statements, consolidates scattered legacy guidance, and updates cross-references throughout the Codification
  - It does **not** add to or reduce existing disclosure requirements
- The central theme of the ASU is an **explicit** requirement to disclose events that occur after the end of the last annual reporting period that have a material impact on the entity
  - Topic 270 now directs preparers to consider applicable annual disclosure requirements as the baseline for explaining material interim events, rather than relying on minimal or generic quarterly descriptions

ASU 2025-11: Main Provisions

- Reorganized interim reporting framework
  - Topic 270 is restructured to articulate a clearer disclosure principle: interim financial statements must include the information necessary to avoid being misleading, taking into account users' access to the latest annual financial statements
  - The guidance now delineates (a) general interim disclosure principles, (b) minimum required disclosures, and (c) how interim requirements in other Topics interact with Topic 270
- Explicit requirement to disclose material post–year-end events
  - New paragraphs 270-10-50-68 through 50-70 require disclosure of material events occurring after the last annual reporting period that significantly affect the entity, such as major estimate changes, impairments, restructurings, financing changes, and business combinations
  - Preparers must look to annual disclosure requirements for the relevant Topic to determine the scope of interim disclosure for these events

ASU 2025-11: Main Provisions

- Clarification of when annual disclosures are needed in interim periods
  - Preparers must provide annual-type disclosures when necessary to explain a material interim event but need not repeat annual disclosures that have not changed
  - Continuing contingencies and uncertainties must be disclosed and repeated at each interim date until resolved or immaterial
- Conforming amendments across the Codification
  - More than 100 conforming amendments revise interim disclosure references in Topics including fair value, credit losses, financial instruments, segments, revenue, leases, and insurance
    - These amendments do not add new disclosures; they align terminology and cross-references with the reorganized Topic 270

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ASU 2025-11: Effective Date and Transition

- This ASU is effective for interim reporting periods within annual reporting periods beginning after December 15, 2027, for public business entities and for interim reporting periods within annual reporting periods beginning after December 15, 2028, for entities other than public business entities
  - Early adoption is permitted

ASU No. 2025-10, *Government Grants (Topic 832): Accounting for Government Grants Received by Business Entities*

- Establishes, for the first time, authoritative U.S. GAAP on the accounting for government grants received by business entities
- Historically, business entities relied on IAS 20, Topic 450, or portions of Subtopic 958-605 by analogy, resulting in persistent diversity in practice
- Despite the introduction of disclosure-only requirements in Update 2021-10, stakeholders, including preparers, auditors, and investors, noted that recognition and measurement remained unaddressed areas of inconsistency

ASU 2025-10: Reason for Issuance

- Prior to this Update, U.S. GAAP lacked explicit guidance on government grants issued to business entities
- Stakeholder feedback emphasized that increased federal and state grant activity, including programs tied to pandemic relief and climate-related legislation, magnified the need for authoritative GAAP
- Preparers and auditors stressed the need for clarity regarding when grants should be recognized, especially when conditions span multiple periods, and how repayable or forgivable arrangements should be handled
- Replaced the current reliance on nonauthoritative analogies

ASU 2025-10: Main Provisions

- ASU 2025-10 provides a unified GAAP model for recognition, measurement, and presentation of government grants. The amendments apply to business entities and exclude not-for-profit organizations and employee benefit plans
  - A government grant is defined as a transfer of a monetary or tangible nonmonetary asset from a governmental entity, outside of an exchange transaction
- **Recognition threshold** – A government grant received by the entity cannot be recognized until two criteria are met:
  a. It is probable that the entity will (1) comply with any attached grant conditions, and (2) the entity will receive the grant; and
  b. A business entity meets the recognition guidance for a grant related to an asset or a grant related to income

ASU 2025-10: Main Provisions – Grants Related to Assets

- For a government grant conditioned on the purchase, construction, or acquisition of an asset, an entity must choose one of two recognition approaches:
  a. **Deferred income approach** – The grant is recorded as deferred income on the balance sheet and amortized to earnings in a systematic and rational manner as the related asset costs are recognized (for example, through depreciation, impairment, or sale)
  b. **Cost accumulation approach** – The grant reduces the cost basis of the related asset. Under this approach, no separate subsequent recognition of grant income occurs; instead, the reduced cost basis yields lower depreciation or gains/losses over the asset's life
- The ASU retains optionality because stakeholders and Board members could not agree on a single model (over the dissent of the three Board members), and many preparers already use both by analogy

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ASU 2025-10: Main Provisions

- **Grants related to income** – Grants not directly tied to the acquisition of an asset are treated as income grants. These are recognized in earnings on a systematic and rational basis over the periods in which the entity incurs the expenditures the grant is intended to reimburse. Grants intended to compensate for prior expenditures or provide immediate financial support are recognized when the recognition threshold is met (Summary, p. 7)
- Measurement of tangible nonmonetary grants
  - Entities receiving nonmonetary assets (such as land or equipment) may:
    - Measure the asset at fair value under the deferred income approach if the grant is related to an asset; or
    - Measure it at cost to the entity under the cost accumulation approach (Codification 832-10-30-1)

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ASU 2025-10: Main Provisions

- If a grant becomes repayable (e.g., when conditions are not met), the repayment is accounted for based on the nature of the underlying grant (832-10-35-1):
  - **Income grants** – Repayments first reduce any unamortized deferred income; excess repayments are recognized immediately in earnings
  - **Asset grants** – Repayments either increase the asset's carrying amount (cost accumulation approach) or reduce the deferred income balance (deferred income approach), with any excess also recognized in earnings

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ASU 2025-10: Presentation and Disclosure

- Grant proceeds may be presented in earnings either:
  - As other income; or
  - As a deduction from related expenses (Summary, p. 7)
- Entities must disclose (832-10-50-3 and 50-3A–C):
  - The nature and form of the grant;
  - Accounting policies applied (including which approach is used for asset grants) – "for example, for a grant related to an asset, whether the deferred income approach or the cost accumulation approach is applied, or for a grant related to income, whether the grant is presented separately under a general heading such as other income or deducted from the related expense";
  - Significant terms and conditions of the grant;
  - Affected financial statement line items and amounts;
  - For tangible nonmonetary grants, the fair value in the period recognized

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ASU 2025-10: Effective Date and Transition

- The amendments become effective as follows (Summary, pp. 8–9):
  - **Public business entities** – Annual periods beginning after December 15, 2028, and interim reporting periods within those annual periods
  - **All other entities** – Annual periods beginning after December 15, 2029, and interim reporting periods within those annual periods
  - **Early adoption** is permitted in both interim and annual reporting periods
- Entities may choose among **three** transition methods:
  a. **Modified prospective** – Apply to grants entered into on or after the effective date and to incomplete grants – no restatement and no cumulative-effect adjustment
  b. **Modified retrospective** – Restate only incomplete grants as of the earliest period presented, with a cumulative-effect adjustment to the opening balance of retained earnings
  c. **Full retrospective** – Restate all periods presented with a cumulative-effect adjustment to the opening balance of retained earnings

ASU No. 2025-09, *Derivatives and Hedging (Topic 815): Hedge Accounting Improvements*

- ASU 2025-09 introduces targeted improvements to hedge accounting to enhance operability, address areas of diversity in practice, and respond to market developments following global reference rate reform
- The Update is consistent with the original objective of ASU 2017-12 and focuses on five issues:
  1. Similar risk assessment for cash flow hedges
  2. Hedging forecasted interest payments on choose-your-rate instruments
  3. Hedge accounting for nonfinancial forecasted transactions
  4. Net written options in hedge relationships
  5. Foreign-currency-denominated debt instruments as hedging instrument and hedged item (dual hedge)

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ASU 2025-09: Reason for Issuance

- Following Update 2017-12, stakeholders continued to request clarification on several hedge accounting topics, including application of similar risk assessments, designation of hedged risks, and treatment of basis adjustments in dual hedges
- In addition, the cessation of LIBOR created new complexities for hedging strategies involving interest rate swaps and optionality embedded in debt instruments
- The Board responded with a targeted yet comprehensive refinement designed to align accounting more closely with contemporary risk management strategies

ASU 2025-09: Main Provisions

Issue 1: Similar risk assessment for cash flow hedges

- The Update fundamentally reshapes how entities determine whether a group of individual forecasted transactions may be designated together in a single cash flow hedge. Under prior guidance, forecasted transactions needed to have a shared risk exposure, a requirement interpreted narrowly in practice and one that often prevented entities from grouping transactions that were economically similar but not perfectly aligned in timing, volume, or rate sensitivity. ASU 2025-09 replaces the "*shared risk exposure*" standard with a more flexible "**similar risk exposure**" requirement
- Under the new standard, a group of forecasted transactions qualifies for hedge designation if the derivative hedging instrument is highly effective in offsetting the designated risk for each hedged risk in the group

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ASU 2025-09: Main Provisions

Issue 2: Hedging forecasted interest payments on choose-your-rate debt instruments

- The Update introduces a new model designed specifically for choose-your-rate debt, which contains contractual provisions permitting the borrower to change both the interest rate index and the interest-rate tenor (for example, switching from SOFR one-month to SOFR three-month)
- Under the previous guidance, such contractual optionality risked triggering dedesignation because a change in index or tenor constituted a change in the hedged risk, even if the borrower's intent and exposure were economically continuous
- ASU 2025-09 establishes a structured framework permitting entities to apply hedge accounting to forecasted or existing interest payments on choose-your-rate debt without dedesignating the hedging relationship when contractual terms change
- The Update allows entities to use simplified probability assessments and streamlined hedge-effectiveness evaluations when the debt terms meet the criteria for choose-your-rate treatment. An entity may apply this model to existing, forecasted issuances of, and subsequent replacements of choose-your-rate debt
    - Entities are prohibited from applying this guidance by analogy to other circumstances

ASU 2025-09: Main Provisions

Issue 3: Cash flow hedges of nonfinancial forecasted transactions

- This issue expands hedge accounting eligibility for forecasted purchases and sales of nonfinancial assets, particularly in industries such as energy, manufacturing, chemicals, and agriculture, where entities routinely face exposure to variable underlying inputs or referenced pricing components
- ASU 2025-09 moves away from the contractual-specification requirement and instead permits designation of variable price components that are **clearly and closely related** to the nonfinancial asset being acquired or sold
  - This includes components embedded in spot-market transactions and forward-market transactions, as well as subcomponents of explicitly referenced pricing components in an agreement's pricing formula
  - To qualify for hedge designation, the variable price component of the forecasted purchase or sale of a nonfinancial asset is required to be clearly and closely related to the NFA being purchased or sold in the current normal purchases and normal sales exception
- The amendment further clarifies that entities may designate a variable price component in a contract that is accounted for as a derivative as the hedged risk if all other hedge criteria are satisfied
- The shift is significant. It acknowledges that contracts often reference only broad pricing mechanisms or indices, while economic exposure may stem from underlying elements within those mechanisms

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ASU 2025-09: Main Provisions

Issue 4: Net written options as hedging instruments

- In response to the elimination of LIBOR, ASU 2025-09 eliminates the requirement to apply the net written option test to certain compound derivatives that include both a swap component and a written option designated as the hedging instrument in a cash flow hedge or fair value hedge of interest rate risk

Issue 5: Foreign-currency-denominated debt instrument as hedging instrument and hedged item (dual hedge)

- A dual hedge strategy is a hedge for which a foreign-currency-denominated debt instrument is both designated as the hedging instrument in a net investment hedge and designated as the hedged item in a fair value hedge of interest rate risk
- ASU 2025-09 resolves this issue by requiring entities to exclude the debt instrument's fair value hedge basis adjustment from the net investment hedge effectiveness assessment. As a result, gains and losses from remeasuring the debt instrument's fair value hedge basis adjustment at spot exchange rates are recognized immediately in earnings

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ASU 2025-09: Effective Date and Transition

- For public business entities, ASU 2025-09 is effective for annual reporting periods beginning after December 15, 2026, and interim periods within those annual reporting periods
  - Early adoption is permitted
- For entities other than public business entities, the amendments are effective for annual reporting periods beginning after December 15, 2027, and interim periods within those annual reporting periods
  - Early adoption is permitted
- The Update is applied prospectively for all hedging relationships, and entities may modify hedge documentation for existing hedges without dedesignating the hedge, allowing for smooth transition and operational continuity
  - The entity may elect to adopt the ASU for hedging relationships that exist as of the date of adoption even if they originated prior to adoption

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ASU No. 2025-08, *Financial Instruments – Credit Losses (Topic 326): Purchased Loans*

- ASU 2025-08 revises the accounting for acquired loans under Topic 326 by expanding the population of assets subject to the gross-up approach and reducing those subject to credit loss expense on day one
- Historically, the distinction between purchased credit-deteriorated (PCD) and non-PCD loans created inconsistent and sometimes uneconomic results, particularly where non-PCD loans produced day-one credit loss expense despite expected credit losses already reflected in fair value
- This Update introduces the concept of purchased seasoned loans (a new term) and significantly reduces reliance on subjective credit-quality assessments
  - It aligns acquisition accounting with the economic substance of purchased loan portfolios

ASU 2025-08: Reason for Issuance

- Following the issuance of ASU 2016-13, the Board monitored implementation through its post-implementation review (PIR) process
- Stakeholders identified two key challenges:
  a. The operational difficulty of consistently distinguishing PCD from non-PCD loans; and
  b. The uneconomic day-one loss recognition required for non-PCD assets
- Investors described this treatment as “double counting” because expected credit losses were reflected both in the acquisition date fair value and in the newly recorded expense and related allowance

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ASU 2025-08: Main Provisions

- Introduces purchased *seasoned* loans by deeming all non-PCD loans acquired in a business combination as seasoned and by requiring other acquired loans to be evaluated using bright-line seasoning criteria
- All non-PCD loans (excluding credit cards) that are acquired in a business combination are deemed **seasoned**
- A loan is also seasoned if:
  a. It is purchased more than 90 days after origination; and
  b. The acquirer was not involved in the origination of the loan
- Purchased seasoned loans are accounted for under the gross-up approach, which adds the initial allowance for credit losses to the purchase price to determine the loan's amortized cost basis

ASU 2025-08: Effective Date and Transition

- Effective for annual periods beginning after December 15, 2026, including interim periods within those annual reporting periods
  - Early adoption is permitted
- The Update must be applied prospectively to loans acquired on or after the application date. Entities adopting in an interim period must apply the amendments either at the start of the interim period of adoption or the beginning of the annual period that includes that interim period

ASU No. 2025-07, *Derivatives and Hedging (Topic 815) and Revenue From Contracts With Customers (Topic 606)*

- This dual-issue Update modernizes and clarifies the accounting treatment for two areas of concern, derivatives (Topic 815) and revenue (Topic 606):
    1) The scope of derivative accounting for contracts linked to an entity's own operations or performance; and
    2) The accounting for share-based noncash consideration received from customers in revenue contracts
- The amendments are designed to reduce unnecessary complexity, enhance consistency across entities, and better align financial reporting with economic substance

ASU 2025-07: Reason for Issuance

- Stakeholders raised concerns that the definition of a derivative under Topic 815 had become too broad, leading to unintuitive results for contracts based on operational or entity-specific variables
  - For example, funding or licensing arrangements tied to regulatory milestones or internal financial performance measures were sometimes treated as derivatives subject to fair value accounting, even though such treatment did not reflect their underlying economics
- The Board also observed diversity in accounting for share-based noncash consideration received from customers under Topic 606
- This ASU addresses both issues to simplify application and enhance comparability across industries

ASU 2025-07: Main Provisions (Derivatives)

- Refines the scope of derivative accounting under Topic 815 by expanding the existing scope exception to exclude certain non-exchange-traded contracts with underlyings based on operations or activities specific to one of the parties to the contract
- Under the revised derivative guidance, contracts are excluded from Topic 815 if their settlement depends on operational or activity-based variables such as an entity's own earnings, sales volumes, or the occurrence of events like regulatory approval or a greenhouse gas reduction target
  - However, the exception does not apply to variables tied to market rates, prices, or indexes; the price or performance of a financial asset or liability; contracts involving the issuer's own equity (Subtopic 815-40); or call and put options on debt instruments. This principles-based refinement aims to improve alignment between financial reporting and the economic substance of such agreements

ASU 2025-07: Main Provisions (Topic 606)

- Clarifies that share-based noncash consideration from a customer in a revenue contract should be accounted for under Topic 606 until the entity's right to receive or retain the share-based instrument is unconditional
- For share-based noncash consideration, the ASU clarifies that an entity should apply Topic 606's noncash consideration guidance (paragraphs 606-10-32-21 through 32-24) when it receives shares, warrants, or other equity instruments from a customer as payment for goods or services
- The entity should recognize revenue as it satisfies performance obligations, and the share-based instruments should not be recognized as derivative assets or equity securities until the right to receive them becomes unconditional

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ASU 2025-07: Impacted Entities and Effective Date

- Effective for all entities for annual reporting periods beginning after December 15, 2026, including interim periods within those years
  - Early adoption is permitted
- Entities may apply the guidance either prospectively to new contracts entered into on or after the adoption date or on a modified retrospective basis through a cumulative-effect adjustment to opening retained earnings
- The Board also allows, on an instrument-by-instrument basis, an election to continue or revoke the fair value option for contracts affected by the new scope exception
- Must describe the nature and reason for the accounting change and its cumulative impact on equity

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ASU No. 2025-06, *Intangibles – Goodwill and Other – Internal-Use Software (Subtopic 350-40): Targeted Improvements to the Accounting for Internal-Use Software*

- The FASB issued this Update in response to extensive stakeholder feedback that the existing guidance for accounting for internal-use software had become outdated
- Previous requirements relied on a stage-based model (preliminary, application development, and post-implementation) that aligned with the traditional "waterfall" method of software development
- Most entities now use incremental and iterative approaches such as agile methodologies. As a result, the prior framework was difficult to apply and did not reflect the way software is currently developed

ASU 2025-06: Main Provisions

- ASU 2025-06 eliminates the prescriptive references to project stages and introduces a recognition threshold based on management authorization and the probability of completion. Under the new model, capitalization of software costs begins only when (1) management has authorized and committed to funding the computer software project, and (2) it is probable that the project will be completed and the software used as intended. This threshold is referred to as the "probable-to-complete" recognition threshold
- The Update requires entities to evaluate whether "significant development uncertainty" exists before capitalization can begin. Two factors indicate that such uncertainty exists:
    a. "The software being developed has technological innovations or novel, unique, or unproven functions or features, and the uncertainty related to those technological innovations, functions, or features, if identified, has not been resolved through coding and testing"
    b. "The significant performance requirements of the software have not been identified, or the identified significant performance requirements continue to be substantially revised"
- If either factor is present, capitalization must be delayed until the uncertainty is resolved

ASU 2025-06: Main Provisions

- The amendments also revise disclosure requirements. All capitalized internal-use software costs must follow the Property, Plant, and Equipment disclosure model under Subtopic 360-10, rather than the intangible asset disclosure requirements under Subtopic 350-30. Furthermore, the Update supersedes Subtopic 350-50 on website development costs and incorporates relevant website-specific guidance into Subtopic 350-40
- For most entities, the amendments are not expected to result in significant changes to the amount of capitalized costs. However, for software developed for delivery through cloud computing arrangements, the new guidance may result in reduced capitalization and more frequent immediate expense recognition

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ASU 2025-06: Impacted Entities and Effective Date

- ASU 2025-06 is effective for **all entities** for annual reporting periods beginning after December 15, 2027, including interim periods within those years
  - Early adoption is permitted in an interim or annual reporting period in which financial statements have not yet been issued or made available for issuance. If an entity adopts the ASU in an interim reporting period, it shall adopt the ASU as of the beginning of the annual reporting period that includes that interim reporting period
- Entities may apply the amendments using one of three transition methods:
  1) A prospective approach applying the guidance only to new costs incurred after adoption;
  2) A modified approach in which in-process projects that no longer meet the capitalization criteria are derecognized through a cumulative-effect adjustment; or
  3) A full retrospective approach with cumulative-effect adjustment to retained earnings

ASU No. 2025-05, *Financial Instruments – Credit Losses (Topic 326)*

- Issued to simplify the application of ASC 326 to **current accounts receivable** and **current contract assets** arising from transactions accounted for under ASC 606 (revenue)
- The PCC indicated that private entities were struggling with implementation costs and estimating credit losses under the standard despite the application of the standard not having a material impact on the entities
- The PCC further indicated that many private entities were recognizing credit losses as of the balance sheet date for amounts that were ultimately collected before the financial statements were made available

ASU 2025-05: Main Provisions

- The ASU provides **all** entities with a practical expedient and **entities other than public business entities** with an accounting policy election when estimating expected credit losses for current accounts receivable and current contract assets arising from transactions accounted for under Topic 606
  - **Practical expedient (available to all entities, public and private)** – In developing reasonable and supportable forecasts as part of estimating expected credit losses, all entities may elect a practical expedient that assumes that current conditions as of the balance sheet date do not change for the remaining life of the asset
  - **Accounting policy election (available to nonpublic entities only)** – An entity that elects the practical expedient is permitted to make an accounting policy election to consider collection activity after the balance sheet date when estimating expected credit losses (ASU 2025-05)

ASU 2025-05: Main Provisions

- If applicable, nonpublic entities may adopt both provisions:
  - Practical expedient; and
  - Policy election
- If adopting ASU 2025-05, an entity must apply expedient and/or election consistently across applicable balances
- Customer-specific risks must still be considered
- Disclosures must contain the election being made (policy election and/or practical expedient) and the date of the assessment being performed if such elections are made

ASU 2025-05: Impacted Entities and Effective Date

- The practical expedient applies to all entities, public and private, while the policy election applies to entities other than public entities
- The ASU is effective for annual periods beginning after December 15, 2025, including interim periods within
  - Early adoption was permitted
- The practical expedient and/or policy election should be applied **prospectively**
- A preferability assessment is not required for nonpublic entities adopting the practical expedient or policy election after the effective date

Discussion Question:

Given the focus the PCC places on making standards less burdensome for preparers, what are some reasons your clients may be giving for not implementing the accounting policy election or practical expedient allowed under ASU 2025-05?

ASU No. 2025-04, *Share-Based Consideration Payable to a Customer*

- Issued to resolve diversity in practice and improve the clarity and operability of existing guidance related to share-based consideration (e.g., warrants, options, other equity instruments) granted to customers to incentivize them to purchase goods or services
- Designed to address uncertainty in distinguishing between service conditions and performance conditions
- This ASU aims to ensure that revenue recognition reflects the economic substance of customer awards, especially when vesting is tied to purchase volume or value, and better aligns guidance for these awards with the principles of ASC 606 and ASC 718

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ASU 2025-04: Main Provisions

- The ASU redefines the term *performance condition* in the Master Glossary to include vesting targets based on the volume or monetary amount of purchases as follows:
- “For share-based consideration payable to a customer that can result in a reduction of the transaction price in accordance with Topic 606, a condition affecting the vesting, exercisability, exercise price, or other pertinent factors used in determining the fair value of an award that relates to any of the following:
  - Achieving a specified performance target that is defined solely by reference to the grantor’s own operations (or activities) or by reference to the grantee’s (the customer’s) performance related to the grantor’s own operations (or activities)
  - The grantee’s purchase (or potential purchase) of the grantor’s goods or services from either the grantor or the grantor’s customers
  - A purchase (or potential purchase) of the grantor’s goods or services from either the grantee or the grantee’s customers”

ASU 2025-04: Main Provisions

- For awards with service conditions, the ASU eliminates the forfeitures-as-they-occur election and instead requires entities to estimate forfeitures
- The amendment further clarifies that the ASC 606 constraint on variable consideration does not apply to share-based customer awards
  - The grantor is required to only apply Topic 718 to such scenarios
- Revenue recognition will no longer be delayed when an entity grants awards that are not expected to vest, allowing a better initial estimate of the transaction price under ASC 606

ASU 2025-04: Impacted Entities and Effective Date

- Applies to all entities, public and private, issuing share-based consideration to customers in the scope of Topic 606
- ASU is effective for all entities for annual reporting periods (including interim reporting periods within annual reporting periods) beginning after December 15, 2026
  - Early adoption is permitted
- Modified retrospective (default) or full retrospective adoption is permitted

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ASU 2025-04: Transition – Modified Retrospective

- The grantor should recognize a cumulative-effect adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) as of the beginning of the period of adoption
  - The grantor should not recast any financial statement information before the period of adoption
- The grantor should apply the amendments as of the date of initial application to all share-based consideration payable to a customer

ASU 2025-04: Transition – Retrospective

- The grantor should recast comparative periods and recognize a cumulative-effect adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) as of the beginning of the earliest period presented
- An entity that elects to apply the guidance retrospectively should use the actual outcome, if known, of a performance condition or service condition as of the beginning of the annual reporting period of adoption for all prior-period estimates
  - If actual outcomes are unknown as of the beginning of the annual reporting period of adoption, an entity should use its estimate of the probability of achieving a service condition or performance condition as of the beginning of the annual reporting period of adoption for all prior-period estimates

ASU No. 2025-03, *Business Combinations (Topic 805) and Consolidation (Topic 810): Determining the Accounting Acquirer in the Acquisition of a Variable Interest Entity*

- The FASB issued ASU 2025-03 to address inconsistencies in the determination of the accounting acquirer in transactions where a variable interest entity (VIE) is acquired
- Under prior guidance, the primary beneficiary of a VIE was **always** considered the accounting acquirer, even when the transaction was effected by exchanging equity interests. Stakeholders raised concerns about lack of comparability between VIE and non-VIE transactions, especially regarding reverse acquisitions and whether a business combination had occurred
- The amendments aim to enhance consistency and comparability by allowing the same accounting acquirer assessment factors that are currently required for determining which entity is the accounting acquirer in other acquisition transactions

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ASU 2025-03: Main Provisions

- The ASU modifies Topic 805 and Topic 810 to require entities to apply the same set of factors (outlined in ASC 805-10-55-12 through 55-15) to determine the accounting acquirer when:
  - The legal acquiree is a VIE;
  - The legal acquiree meets the definition of a business; and
  - The transaction is effected primarily by exchanging equity interests
- Previously, the primary beneficiary was **always** the acquirer for VIEs
  - **The ASU removes that automatic designation** in the specific case of equity exchange transactions
- The factors to consider include relative voting rights, governing body composition, senior management continuity, and size of the entities involved. The ASU does not change the accounting for reverse acquisitions or acquisitions where the legal acquiree is not a business

ASU 2025-03: Impacted Entities, Transition, and Effective Date

- This Update affects all entities involved in acquisition transactions effected primarily by exchanging equity interests when the legal acquiree is a VIE that meets the definition of a business
- ASU 2025-03 is effective for all entities for annual reporting periods beginning after December 15, 2026, including interim periods within those annual periods
  - Early adoption is permitted at the beginning of any interim or annual reporting period where financial statements have not yet been issued or made available for issuance
- The amendments must be applied prospectively to any qualifying acquisition transactions occurring after the initial application date

Chapter 2

Compensation for Passthrough Entity Owners

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Introduction

- Compensation planning is a fundamental annual requirement for every S corporation and partnership
- The risks of inadequate planning are significant, including the retroactive reclassification of distributions, employment tax assessments, and accuracy-related penalties under §6662
- In recent years, the IRS has increased enforcement efforts targeting passthrough entities, with reasonable compensation becoming one of the most scrutinized, high-risk areas in small business tax planning
- This chapter focuses on the reasonable compensation framework for S corporations and the guaranteed payment framework for partnerships, as well as the IRS enforcement environment, and the OBBBA's new interactions that affect compensation decisions

II. Reasonable Compensation
A. The Root of the Problem

- Business owners generally contribute both capital and labor to their business
- **Capital contributions** such as money, property, or other assets invested in the business, generate a return in the form of **distributions** of profit and capital gains
- On the other hand, **labor contributions**, including any work the owner performs, whether producing goods or providing services or managerial oversight to the business, generate compensation in the form of **wages/salary**
- These two types of income are economically distinct and treated differently under tax law, notably for the Federal Insurance Contributions Act (FICA) tax
  - FICA is inherently designed to apply to labor income, such as wages and salaries that compensate employees for work they perform
  - FICA does not apply to capital income, such as distributions of business profits
- Both wages and distributions flow from the S corporation to the same owner, so there is a ***direct financial incentive*** for S corporation owners to minimize the wage component, since wages are subject to FICA while distributions are not

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II. Reasonable Compensation
B. The Statutory and Regulatory Foundation

- S corporation shareholder-employees essentially occupy two roles simultaneously:
  - As **shareholders,** they receive distributions of profit; and
  - As **employees,** they receive wages for services rendered
  - The **reasonable compensation** requirement governs the division between those two categories
- The **reasonable compensation** requirement for S corporation shareholder-employees does not arise from a single dedicated statute. Rather, it is the product of several converging legal authorities that, taken together, establish both the obligation and its enforcement mechanism
- Under IRC §3121(d)(1) and (2), an **employee** for FICA tax purposes means any officer of a corporation
  - The fact that an officer is also a shareholder *does not change* the requirement that payments to the corporate officer be treated as wages

II. Reasonable Compensation
B. The Statutory and Regulatory Foundation

- IRC §3111 and §3121 impose the employer's share of FICA taxes on wages paid to employees
- Treas. Reg. §31.3121(d)-1(b) provides that an **officer** of a corporation is an employee of that corporation
- When analyzed together, these provisions establish that a shareholder who performs services for an S corporation and holds an officer position is an **employee** of that corporation and is thus subject to FICA taxes on compensation received
- Courts have consistently held that S corporation officer/shareholders who provide *more than minor services* to their corporation and receive or are entitled to receive payment are **employees**, and thus their compensation is subject to FICA taxes
- Lastly, the Form 1120-S Instructions directly state that "distributions and other payments by an S corporation to a corporate officer must be treated as wages to the extent the amounts are **reasonable compensation** for services rendered to the corporation"

II. Reasonable Compensation
C. IRS Fact Sheet 2008-25

- IRS Fact Sheet 2008-25, "Wage Compensation for S Corporation Officers," remains the IRS's clearest and arguably most frequently cited statement of its position on reasonable compensation and the factors it considers in evaluating whether an S corporation owner's compensation is reasonable
- Despite its 2008 issuance date, FS-2008-25 accurately reflects the current enforcement framework and is often cited in IRS examination reports and Tax Court opinions
- The fact sheet reiterates that corporate officers are ***specifically included*** within the definition of employee for FICA (Federal Insurance Contributions Act), FUTA (Federal Unemployment Tax Act) and federal income tax withholding under the Internal Revenue Code
- As such, reasonable compensation is subject to 15.3% self-employment taxes (combined employee/employer portion of Social Security and Medicare tax), whereas distributions from an S corporation are not subject to these taxes

II. Reasonable Compensation
C. IRS Fact Sheet 2008-25

- FS-2008-25 further states that when corporate officers perform services for the corporation, and receive or are entitled to receive payments, their compensation is generally considered wages
- An S corporation must pay reasonable compensation to a shareholder-employee in return for the services provided ***before a distribution may be given to the shareholder-employee***
- The Treasury Regulations provide an **exception** for an officer of a corporation who does not perform any services or performs only minor services and who neither receives nor is entitled to receive, directly or indirectly, any remuneration
  - Such an officer would not be considered an employee, and the reasonable compensation requirement would not apply

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II. Reasonable Compensation
C. IRS Fact Sheet 2008-25

- FS 2008-25 is explicit about the avoidance strategies the IRS targets, stating: “corporations should not attempt to avoid paying employment taxes by having their officers treat their compensation as cash distributions, payments of personal expenses, and/or loans rather than as wages”
- FS-2008-25 outlines the following factors considered by the courts in determining reasonable compensation
- **No single factor is determinative**, and the analysis requires *weighing all facts and circumstances*

II. Reasonable Compensation
C. IRS Fact Sheet 2008-25

- **Training and Experience**: Specialized training, advanced credentials, or a depth of technical expertise likely justifies an above-market compensation compared to a more generalized peer
  - For example, a shareholder-employee with 25 years of surgical experience commands different compensation than a newly licensed practitioner performing the same procedures
  - The analysis should consider specific credentials, years of practice, and any specialized expertise that differentiates the shareholder-employee from a typical market-rate employee in the same role

II. Reasonable Compensation
C. IRS Fact Sheet 2008-25

- **Duties and Responsibilities**: This factor considers the depth and scope of the shareholder-employee’s role in the business
  - If gross receipts are generated primarily by the shareholder's personal services, a larger portion of payments should be classified as wages
  - Similarly, even if a shareholder does not directly produce revenue, they must still be paid for administrative work that supports other income-producing employees or assets
  - A manager who does not directly generate gross receipts but oversees employees who do is still performing compensable services

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II. Reasonable Compensation
C. IRS Fact Sheet 2008-25

- **Time and Effort Devoted to the Business:** Part-time involvement often justifies lower compensation than a full-time counterpart, but the analysis hinges on what the market would pay for the actual hours and level of engagement, not on an arbitrary hourly proration
  - A shareholder-employee who works 20 hours per week likely would not receive the same compensation as one working 60 hours per week in the same role
- **Dividend History**: A history of substantial distributions relative to compensation is itself a red flag indicator of potential unreasonableness to the IRS. Similarly, a sudden shift from paying a regular salary to taking only distributions is a red flag indicator

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II. Reasonable Compensation
C. IRS Fact Sheet 2008-25

- **Payments to Non-Shareholder Employees:** When non-shareholder employees performing less complex or less senior roles are paid more than a shareholder-employee, the corporation's own compensation practices become evidence against the reasonableness of the shareholder-employee's wages
  - In other words, the IRS can use the corporation's own payroll data as a benchmark
- **Timing and Manner of Paying Bonuses to Key People:** Lump-sum year-end payments characterized as wages, especially when regular periodic payroll was not maintained, raise questions about whether the amounts truly reflect ongoing compensation for services or a retroactive adjustment motivated by tax considerations
  - The IRS views regular periodic payroll as evidence of genuine employment, whereas year-end lump sums may raise red flags

II. Reasonable Compensation
C. IRS Fact Sheet 2008-25

- **What Comparable Businesses Pay for Similar Services:** The market-rate standard is arguably the most objective and most defensible element of any reasonable compensation analysis
  - The IRS defines **reasonable compensation** as the amount that would ordinarily be paid for like services by like enterprises under similar circumstances
  - Compensation data sources include the U.S. Bureau of Labor Statistics Occupational Employment and Wage Statistics (OEWS) database, industry compensation surveys published by trade associations, the Robert Half Salary Guide, the Management of an Accounting Practice survey published by the AICPA, and comparable W-2 data from similarly situated employees in the client's geographic market
  - The IRS uses BLS data in examinations, making it a primary reference point in any reasonable compensation dispute

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II. Reasonable Compensation
C. IRS Fact Sheet 2008-25

- **Compensation Agreements and Formula-Based Approaches:** The existence of a formally adopted compensation policy, approved by the board or shareholders, documented in minutes, and consistently applied, often supports the reasonableness of the compensation determination regardless of the specific amount
  - Note: This is only true if the formula itself produces a market-rate result
  - A formula that produces below-market compensation is not protected simply by its formal adoption

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II. Reasonable Compensation
D. The Case Law Landscape

- The Tax Court and circuit courts have consistently supported the IRS in reasonable compensation disputes
- ***Veterinary Surgical Consultants v. Commissioner, 117 T.C. 141 (2001):***
  - In 2001, in a Tax Court case against a Veterinary Clinic, the Tax Court ruled that an employer cannot avoid federal taxes by characterizing compensation paid to its sole director and shareholder as distributions of the corporation's net income rather than wages
  - *Veterinary Surgical Consultants* involved a sole shareholder-veterinarian who paid himself minimal wages
  - The Tax Court found that a specialist veterinarian in his position would command substantially higher compensation in the open market and recharacterized the payments accordingly

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II. Reasonable Compensation
D. The Case Law Landscape

- ***Joly v. Commissioner, T.C. Memo. 1998-361 aff'd by unpub. op., 211 F.3d 1269 (6th Cir. 2000):***
  - J. Michael Joly operated J. Michael Joly, Inc., an S corporation engaged in custom home construction, serving as president and the primary reason for the corporation's success in attracting customers
    - His son Jody later joined as vice president and operations manager
  - The corporation paid no wages but made funds available to Michael and Jody by allowing them to use the company bank account for personal use, drawing on corporate funds as their personal needs arose
  - The Tax Court found that the amounts drawn from the corporate account constituted taxable wages for FICA purposes, rejecting the argument that the payments were loans because *no loan documents existed* and the corporation's balance sheets showed *no loans outstanding*
  - The Sixth Circuit affirmed this decision that the shareholder-employee of a company used the company bank account for personal use. As such, the Court ruled that the shareholder was an employee and owed employment tax

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II. Reasonable Compensation
D. The Case Law Landscape

- ***Joseph M. Grey Public Accountant, P.C. vs. Commissioner, 119 T.C. 121 (2002):***
  - An accountant who was the sole officer and shareholder of his professional corporation took all payments in the form of dividends while performing ongoing accounting services for the corporation's clients
  - The Tax Court ruled the dividends were actually wages, subject to employment taxes
  - This decision reiterated the principle that the form of payment is immaterial, rather the relevant question is whether the amounts received were ***in substance*** remuneration for services rendered

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II. Reasonable Compensation
D. The Case Law Landscape

- ***Nu-Look Design, Inc. v. Commissioner, T.C. Memo. 2003-52:***
  - Ronald Stark was the sole shareholder and president of Nu-Look Design, a residential home improvement company
  - During the years at issue, Stark managed the company, solicited business, handled finances, hired workers, and supervised the work, performing the full range of operational functions
  - Nu-Look paid Stark no wages and instead distributed net income to him as his personal needs arose
  - The Tax Court recharacterized the distributions as wages in full, applying the market-rate standard and finding that the corporation provided no credible evidence that the zero-wage position reflected what an unrelated party would accept for the same services
  - The Court relied on the **economic substance** of the payments, concluding that the distributions were, in fact, remuneration for services performed

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II. Reasonable Compensation
D. The Case Law Landscape

- ***Ghosn v. Commissioner, T.C. Memo. 1995-192:***
  - The corporation paid the shareholder's personal expenses for insurance and utilities
  - Payments of an officer's personal expenses *made with compensatory intent* are wages for employment tax purposes
  - The Tax Court found that the corporation's payments of the shareholder's personal expenses for insurance and utilities were made with the intent to compensate the shareholder for services rendered
  - As such, the corporation was entitled to a deduction as additional compensation
  - The amounts when combined with small amounts of "management expenses" paid by the corporation were not unreasonable
    - While the IRS most commonly argues that payments are wages rather than distributions, courts also recognize that non-wage payments made with compensatory intent constitute wages for employment tax purposes

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II. Reasonable Compensation
D. The Case Law Landscape

- One of the most sophisticated avoidance structures litigated in the reasonable compensation context involves characterizing transfers from a corporation to a shareholder-employee as **loans** rather than wages or distributions
- To qualify as a genuine loan, the transaction must meet several formal requirements, including:
  - **Documentation**: A genuine loan requires documentation, including promissory notes or loan agreements executed at the time of the advance, specifying the principal amount, interest rate, maturity date, and repayment terms
  - **Interest Terms**: Interest must be charged at a rate at least equal to the applicable federal rate and repayment according to a specified schedule, not merely when corporate cash is available or at the shareholder’s discretion
  - **Accounting**: The advance must be recorded as a liability on the corporate balance sheet and as a receivable on the shareholder's personal records
  - **Contingency**: Repayment of the advance cannot be dependent entirely on the success of the corporation's business. When a transfer’s repayment depends solely on whether the corporation generates sufficient profits, it has the attributes of a capital contribution, not a loan

II. Reasonable Compensation
D. The Case Law Landscape

- When an S corporation borrows from the shareholder and repays that borrowing through distributions, the repayment of a **legitimate loan obligation** is not characterized as wages
- However, when the corporation advances money to the shareholder and claims repayment was accomplished by crediting the advance against future income or distributions, the transaction often *lacks economic substance*, particularly when no independent economic obligation constrains the timing or amount of repayment
- Courts have consistently **rejected** the loan characterization where the essential attributes of a genuine debt obligation are absent

II. Reasonable Compensation
D. The Case Law Landscape

- ***Gale W. Greenlee, Inc. v. U.S., 661 F. Supp. 642 (D. Colo. 1985)***:
  - **Purported "loans"** from the S corporation to its sole shareholder, officer, and director, were considered wages for purposes of FICA and FUTA taxes
  - The loans were unsecured demand notes bearing no interest, the loans were made entirely at the discretion of shareholder, and the shareholder regularly performed substantial, valuable services for the S corporation
  - The Court found that repayment of loan was "*simply a paper transaction*" in which the outstanding loan balance was credited against undistributed income and rental payments owed by the corporation to the shareholder

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II. Reasonable Compensation
D. The Case Law Landscape

- ***Glass Blocks Unlimited v. Commissioner, T.C. Memo. 2013-180:***
  - Mr. Blodgett, the president of Glass Blocks Unlimited was the only full-time worker, responsible for all operational and financial decisions, and his services generated all of the corporation's income
  - The corporation paid Blodgett no salary or wages, distributing money to him as cash was available and as he requested it
  - During the dispute, the corporation contended that a portion of the distributions represented repayment of loans. Specifically, they argued that Blodgett had transferred funds to the corporation during an economic downturn and that subsequent distributions were merely returning those funds to him
  - Further, there were no promissory notes documenting the alleged loans; there were no loan terms establishing interest, maturity, or repayment schedules; the transfers were not treated as loans on the corporate balance sheet; and repayment depended entirely on the corporation's available cash and the shareholder's requests rather than on any fixed obligation
  - The Court found that payments made by the S corporation to its president and sole shareholder were **wages** subject to employment taxes, not distributions or loan repayments

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II. Reasonable Compensation
D. The Case Law Landscape

- ***Watson v. Commissioner,*** *668 F.3d 1008 (8th Cir. 2012):*
  - Watson is arguably one of the most important and most frequently cited reasonable compensation cases in practice
  - David Watson (Watson) was a Certified Public Accountant who obtained a 25% interest in an accounting firm, Larson, Watson, Bartling & Juffer, LLP (LWBJ). In 1996, Watson incorporated a business entity known as David E. Watson, P.C. (DEWPC)
  - Watson transferred his individual 25% interest in LWBJ to DEWPC, and thereafter DEWPC replaced Watson as a partner in LWBJ
  - Watson served as DEWPC's **sole officer, shareholder, director, and employee**. Through an employment agreement, DEWPC employed Watson, but Watson exclusively provided his accounting services to LWBJ for the period relevant to this dispute
  - From its inception, DEWPC elected to be taxed as an S Corporation
  - For the years at issue, Watson paid himself $24,000 per year (*a fraction of the market rate*) while receiving approximately $200,000 in **distributions** per year for the years at issue (2002 and 2003)
  - Thus, in the years in question, after DEWPC paid Watson's salary and other expenses, it distributed all remaining cash to Watson as dividends

II. Reasonable Compensation
D. The Case Law Landscape

- ***Watson v. Commissioner,*** *668 F.3d 1008 (8th Cir. 2012):*
  - The IRS determined that DEWPC underpaid employment taxes pursuant to FICA for the years at issue
  - At trial, the government's expert, Igor Ostrovsky, stated that the market value of Watson's accounting services was approximately $91,044 per year for the years at issue
  - Ostrovsky relied on several compensation surveys and studies particular to accountants. Primarily, Ostrovsky focused on the Management of an Accounting Practice (MAP) survey conducted by the American Institute of Certified Public Accountants, which contained adjustments for specific regions
  - In resolving this FICA tax dispute, the main issue was whether, based on the statutes and unusual facts involved, the payments made to Watson **were remuneration for services performed**
  - Watson’s primary argument was that there was no statute, regulation, or rule requiring an employer to pay minimum compensation
  - Additionally, by requiring proof of reasonable compensation, DEWPC argued that the district court imposed a **minimum compensation requirement**

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II. Reasonable Compensation
D. The Case Law Landscape

- ***Watson v. Commissioner,*** *668 F.3d 1008 (8th Cir. 2012):*
  - Courts have historically addressed similar FICA characterization issues by evaluating the **economic substance of the transaction rather than the form** chosen by the taxpayer
  - The Court ultimately rejected Watson's characterization and held that the payments Watson received were, in economic substance, remuneration for services performed
  - They concluded that *the characterization of those payments of distributions did not change their underlying character*
  - Ultimately, the Eighth Circuit affirmed the Tax Court's determination that the distributions should be recharacterized as wages, resulting in additional FICA taxes, penalties, and interest
  - The case is significant not only for its outcome but for the court's methodology, as it explicitly compared Watson's compensation to that of similarly qualified CPAs in similar positions, using **industry compensation data** as the benchmark

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II. Reasonable Compensation
E. Reasonable Compensation Analysis

- Ultimately, the foundation of any reasonable compensation analysis is the market-rate determination
  - ***What would the corporation pay an unrelated party to perform the same services under similar circumstances?***
- Ideally, the determination of the reasonableness of an employee's compensation is made by comparing the employee's compensation to that of an employee performing similar duties at a similar company of the same size/industry
- This determination requires understanding both what the role of the shareholder-employee is and what the market pays for those specific services
  - S corporation shareholder-employees frequently perform multiple roles simultaneously
  - Each role has a separate market value
  - The reasonable compensation analysis should identify each role, estimate the time allocation across roles, and apply market-rate compensation for each

II. Reasonable Compensation
F. IRS Enforcement

- The IRS uses various approaches for S corporation compliance
- Examiners within the Small Business/Self-Employed (SB/SE) Division may review officer's compensation as part of examinations of Form 1120-S
- Additionally, Exam Case Selection within the SB/SE Division's Specialty Examination function reviews the officer compensation issue by using the Form 1120-S along with a set of criteria to identify returns with potential employment tax noncompliance
- Finally, the IRS has also used Compliance Initiative Projects (CIP) to focus resources on the issue. CIPs are authorized activities, outside of the planned strategies, with the intended purpose of correcting noncompliance around particular issues or areas of concern
  - In 2009, the IRS created a CIP to address the officer's compensation issue associated with S corporations by developing and using filters to identify high-risk cases, such as S corporations with no officer compensation reported
  - In August 2020, the IRS began its newest CIP associated with the lack of officer's compensation associated with S corporations

IV. Compensation Planning in Light of the OBBBA

A. The Qualified Tips Deduction – New Interaction for Service Industry PTEs

- The OBBBA's new §224 **qualified tip income** deduction creates new compensation considerations for S corporations and partnerships operating in tipping-eligible industries
  - The deduction is available to both employees and self-employed individuals in occupations that customarily receive tips, subject to a $25,000 annual cap and a MAGI phaseout beginning at $150,000 (single) and $300,000 (MFJ)
- For an S corporation shareholder-employee in a qualifying tipped occupation, the deduction under §224 is available individually for any tips received
- However, qualified tips deducted under §224 are excluded from QBI for §199A purposes, meaning that the tip deduction reduces QBI at the individual level in addition to reducing taxable income
  - This double reduction should be explicitly modeled for S corporation taxpayers in a tipping-eligible occupation
- For partnership clients who are self-employed and receive tips from customers, **the net income limitation** for the §224 deduction caps the deductible tips at the net income of the specific trade or business
  - In other words, the partnership's profitability directly affects each eligible partner's available tip deduction

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IV. Compensation Planning in Light of the OBBBA
B. The PTET and SE Tax Interaction

- One of the most significant and often overlooked OBBBA-related compensation considerations for partnership clients is the interaction between PTET elections and self-employment tax
- When a partnership makes a PTET election and the state imposes the PTET on the partnership's ordinary income, the resulting entity-level tax payment reduces the partnership's ordinary income *before* allocation to partners
- Since SE tax for general partners and active LLC members is computed on the partner's distributive share of ordinary income, and because the PTET payment has reduced that ordinary income, the PTET election **effectively reduces the SE tax base for active partners**
- The magnitude of this benefit ultimately depends on the state tax rate, the partner's SE income level relative to the Social Security wage base, and whether the reduced ordinary income keeps the partner below or above the additional Medicare tax threshold
- For a general partner subject to the full 15.3% SE rate on the first $184,500 of net SE income in 2026, each dollar of PTET payment that reduces ordinary income below that threshold produces a **15.3% SE tax savings**, a meaningful amplification of the PTET's federal benefit beyond the SALT cap workaround

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IV. Compensation Planning in Light of the OBBBA

B. The PTET and SE Tax Interaction

- This interaction *does not exist* for S corporation shareholders in the same form, because S corporation distributions are not subject to FICA, and the PTET payment reduces QBI (not subject to FICA) rather than wages (subject to FICA)
- The SE tax dimension of PTET is therefore specific to active partners and LLC members whose entire distributive share is subject to SE tax
- For partnership taxpayers with significant SE tax exposure, the PTET's SE tax interaction is an important component of the full cost-benefit analysis and should be modeled alongside the SALT cap analysis whenever a PTET election is being evaluated

Chapter 3

Miscellaneous Business Considerations

Advanced Practice Issues
A. Section 1244 Small Business Stock Loss Treatment

- Congress recognized that small, closely held corporations often face greater financing challenges than public companies. In order to encourage equity investment in these businesses, §1244 allows investors to deduct certain stock losses as ordinary losses rather than capital losses
- Original shareholder selling §1244 stock at a loss receives ordinary loss deduction
  - Only stock issued directly by the corporation to the taxpayer (or through an underwriter) is eligible. Individuals or partnerships qualify; C corps and S corps don’t
  - Investors must pay money or transfer property to the corporation; stock issued for services does not qualify
  - Common or preferred stock qualify
  - Stock acquired by a transferee – by purchase from another shareholder or by gift or inheritance – does not qualify
- Ordinary loss amount limited to:
  - $100,000 MFJ; and
  - $50,000 for others
- Partnership loss computed separately for each partner

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Advanced Practice Issues
A. Section 1244 Small Business Stock Loss Treatment

- **Other requirements:**
  - Written plan is NOT required
  - Only first $1,000,000 of stock issued
  - §1244 treatment is NOT transferable
  - Corporation must be operating company (5 years or term of existence)
- **Mechanics:**
  - The ordinary loss is reported on Form 4797 (Part II, Ordinary Gains and Losses) and flows to Schedule 1 (Form 1040), line 4
  - Because ordinary losses reduce adjusted gross income, they can also lower income thresholds for other deductions and credits, which can magnify the tax benefit

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Advanced Practice Issues
A. Section 1244 Small Business Stock Loss Treatment

- ***Example 1***
  - **Basic application** – An investor buys $50,000 of stock in a qualifying small corporation and the business fails within a year
  - If the stock does not qualify under §1244, the $50,000 loss is treated as a capital loss and may offset only capital gains plus $3,000 of ordinary income annually
  - By contrast, if the stock does qualify, the full $50,000 is deducted as an ordinary loss in the current year, resulting in a much larger immediate deduction

Advanced Practice Issues

A. Section 1244 Small Business Stock Loss Treatment

- ***Example 2***
  - **Loss exceeding the annual limit** – Suppose a married couple filing jointly invests $120,000 in §1244 stock that becomes worthless
  - Under §1244, they may deduct $100,000 of this loss as an ordinary loss in the year the stock becomes worthless
  - The remaining $20,000 is treated as a capital loss subject to the $3,000 annual ordinary-income offset
  - If the couple has no capital gains and cannot absorb additional capital losses, it may take several years to fully use the remaining $20,000 loss

Advanced Practice Issues

A. Section 1244 Small Business Stock Loss Treatment

- ***Example 3***
  - **Subsequent Owner** – Jerry Stevens invested $30,000 in a new corporation. On January 1, prior year, he sold one-half of his stock for $15,000 to Bill Myers. On December 1, current year, the corporation declared bankruptcy
  - Jerry Stevens could deduct this $15,000 stock loss 100 percent on his Form 1040 for the current year as an ordinary loss
  - Bill Myers' stock loss would not qualify for §1244 treatment since he was not an original owner of the stock
  - Thus, his stock loss would be a long-term capital loss
  - The current year, Myers would deduct $3,000 and carryover $12,000 capital loss to subsequent years

Advanced Practice Issues

A. Section 1244 Small Business Stock Loss Treatment

- ***Example 4***
  - **Partnership investment and multiple partners** – Three partners, Alex, Sam and Taylor, form AST Partnership and invest $450,000 in newly issued stock of StartCo, a qualifying §1244 corporation
  - Each partner's basis is $150,000. After two years, StartCo fails and the stock becomes worthless. On dissolution, the partnership deducts a $450,000 loss
  - Each partner's $150,000 share of the loss is subject to §1244
  - Alex, Sam and Taylor may each deduct $50,000 (single filers) or up to $100,000 if filing jointly
  - Any remaining loss on each partner's share (up to $100,000 if single, $50,000 if joint, depending on filing status) is treated as a capital loss

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Advanced Practice Issues
B. Section 1202 Qualified Small Business Stock

- As discussed, the OBBBA further expanded §1202 for QSBS issued after July 4, 2025
  - Under the OBBBA, investors can qualify for partial exclusions even when stock is held fewer than five years, creating a tiered structure
  - The OBBBA also raises the corporate asset limit and per-issuer exclusion cap
- Noncorporate taxpayer receives capital gain exclusion on sale of stock held for 5 years on the greater of:
  - 10 times taxpayer's basis (annual limitation); or
  - $10,000,000 reduced by gain in prior years (aggregate limitation); $15,000,000 after 7/4/25 (as increased by the OBBBA and indexed for inflation beginning in 2027)
- AMT preference
  - 7% of gain excluded (acquired before 9/28/2010)
  - 0% of gain excluded (on or after 9/28/2010)

Advanced Practice Issues
B. Section 1202 Qualified Small Business Stock

- The percentage of gain that can be excluded depends on when the stock was acquired:

Acquisition Period	Exclusion Percentage	Applicable Tax Rate on Nonexcluded Gain	AMT Preference
Aug. 11, 1993 – Feb. 17, 2009	50 %	Max 28%	42%/28%/7% of Excluded Gain
Feb. 18, 2009 – Sept. 27, 2010	75 %	Max 28%	7% of Excluded Gain
Sept. 28, 2010 – July 3, 2025	100 %	Max 28%	N/A
July 4, 2025 and later (OBBBA)	50 % if held >3 yrs & <4 yrs 75 % if held ≥4 yrs & <5 yrs 100 % if held ≥5 yrs	Max 28%	N/A

Advanced Practice Issues
B. Section 1202 Qualified Small Business Stock

- Must be a C corporation that cannot own:
  - Real estate which > 10% of assets
  - Securities > 10% of net worth
- 80% or more of assets must be used in non-PSC business
- Gross assets at all times through issuance < $50,000,000 ($75 million after 7/4/25; as increased by the OBBBA)
- Passthrough entity ownership of stock (Partnership and S Corp):
  - Interest owned upon acquisition of stock
  - Stock held by passthrough entity for 5 years
  - Gain from passthrough entity limited to ownership interest at acquisition of stock

Advanced Practice Issues

B. Section 1202 Qualified Small Business Stock

- ***Example 1***
  - **Pre-OBBBA 50-percent exclusion** – In 1993, Elaine buys 1,000 shares of a qualified small business for $100,000 ($100 per share)
  - She sells the stock in 2026, after holding it for more than 30 years, for $2 million. Because she acquired the stock in 1993, 50 percent of her $1.9 million gain is excluded under §1202
  - Elaine can exclude $950,000, and the remaining $950,000 is taxed at a 28% rate
  - Of the $950,000 excluded gain, $66,500 ($950,000 x 7% represents an AMT adjustment item)

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Advanced Practice Issues
B. Section 1202 Qualified Small Business Stock

- ***Example 2***
  - **Full exclusion for post-2010 stock** – Carlos acquires 1,000 shares of QSBS for $50,000 on October 11, 2011
  - In 2026 he sells the stock for $5 million
  - Under the 100-percent exclusion applicable to stock acquired after September 27, 2010, Carlos excludes the entire $4.95 million gain, pays no federal income tax on that gain and has no AMT adjustment

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Advanced Practice Issues
B. Section 1202 Qualified Small Business Stock

- ***Example 3***
  - **Tiered exclusion after the OBBBA (3–4 years)** – On August 1, 2026, Lisa invests $200,000 in the original issuance of TechRise Inc. stock, which qualifies as QSBS
  - TechRise grows rapidly and Lisa sells the stock on September 1, 2029—just over three years later—for $1 million
  - Because the stock was issued after July 4, 2025, and held for more than three but less than four years, Lisa qualifies for the 50-percent exclusion
  - Her gain is $800,000 ($1 million minus $200,000 basis)
  - She may exclude $400,000; the remaining $400,000 is taxed at a 28% tax rate and has no AMT adjustment

Advanced Practice Issues

B. Section 1202 Qualified Small Business Stock

- ***Example 4***
  - **Tiered exclusion after the OBBBA (4–5 years)** – Suppose Lisa had instead sold the stock after four years and one month
  - Now she is entitled to a 75-percent exclusion
  - On a $800,000 gain, she may exclude $600,000 ($800k x 75%), leaving $200,000 taxed at a 28% rate and no AMT adjustment

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Advanced Practice Issues
B. Section 1202 Qualified Small Business Stock

- ***Example 5***
  - **Aggregate limit after OBBBA** – David invests $3 million in multiple rounds of QSBS issued by ABC Corp after July 4, 2025
  - Five years after his last tranche of stock purchase(s), he sells his shares for $20 million, realizing a $17 million gain
  - Under the OBBBA, the aggregate exclusion limit is $15 million (indexed for inflation)
  - David can exclude the greater of (a) 10 times his basis ($30 million) or (b) the $15 million aggregate limit
  - Since $30 million is greater, he may exclude up to $30 million of gain
  - Because the gain of $17 million is less than his exclusion limit of $30 million, the total gain of $17 million is excluded, and there is no modification for AMT

Advanced Practice Issues
B. Section 1202 Qualified Small Business Stock

- ***Example 6***
  - **Multiple Holding Periods across Tranches –** David invests $3 million in ABC Corp. stock in three separate tranches after July 4, 2025:
    - Tranche A: $1 million purchased on July 5 2025
    - Tranche B: $1 million purchased on July 5 2026
    - Tranche C: $1 million purchased on July 5 2027
  - On August 1, 2030, David sells all of his ABC shares for $20 million. The sale proceeds are allocated $8 million to Tranche A, $7 million to Tranche B, and $5 million to Tranche C
  - His total basis is $3 million, so his total gain is $17 million

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Advanced Practice Issues
B. Section 1202 Qualified Small Business Stock

- ***Example 6 (cont'd)***
  - **Multiple Holding Periods across Tranches**
  - Under the One Big Beautiful Bill Act (H.R. 1), QSBS issued after July 4, 2025, is eligible for tiered exclusions:
    - 50 % if held more than 3 years but less than 4 years;
    - 75 % if held at least 4 but less than 5 years; and
    - 100 % if held 5 years or more
  - David's tranches therefore qualify as follows:
    - Tranche A (held > 5 years): Gain = $8 M – $1 M = $7M. Tranche qualifies for a 100 % exclusion. All $7 million of gain is excluded
    - Tranche B (held ≈ 4 years): Gain = $7 M – $1 M = $6M. Held slightly more than four years, it qualifies for the 75 % exclusion. Exclude $4.5M ($6M x 75%) and must include the remaining $1.5 million in income taxed up to a 28% tax rate
    - Tranche C (held just over 3 years): Gain = $5 M – $1 M = $4M. Held more than three but less than four years, it qualifies for the 50 % exclusion. David can exclude $2M and must include the remaining $2M to be taxed up to a 28% tax rate

Advanced Practice Issues
B. Section 1202 Qualified Small Business Stock

- ***Example 6 (cont'd)***
  - **Multiple Holding Periods across Tranches**
  - Altogether, David excludes $13.5 million of his $17 million gain. The remaining $3.5 million is taxed up to a 28% rate
  - Note that his potential exclusion limit is the greater of 10x basis (10 × $3 M = $30 M) or $15 M; the $13.5 million exclusion falls below the $30 million cap, so the limit does not restrict him

Advanced Practice Issues
B. Section 1202 Qualified Small Business Stock

- ***Example 7***
  - **Partnership QSBS and pass through limitation** – Ron, Sally and Tom form RST Partnership and purchase $150,000 of QSBS ($50,000 per partner)
  - A year later, Ron and Sally buy out Tom's interest
  - After more than five years from the original purchase date, RST sells the stock for a $180,000 gain
  - The partnership allocates $90,000 of gain each to Ron and Sally
  - Under §1202, each partner can exclude only up to the gain they would have realized if they had never bought Tom's interest
  - Since Ron and Sally originally held one third of the stock, their excludable gain is $60,000 each; the remaining $30,000 each is taxed up to a 28% tax rate

Advanced Practice Issues

B. Section 1202 Qualified Small Business Stock

- **§1202 Considerations and Planning Strategies:**
  - **Stacking the basis limit and aggregate limit;**
  - **Rollovers under §1045;**
  - **State Conformity; and**
  - **AMT Considerations for stock acquired prior to 9/28/2010**

Advanced Practice Issues

B. Section 1202 Qualified Small Business Stock – §1045 Rollovers

- **§1045 Rollovers**
  - §1045 offers investors a deferral mechanism when they sell QSBS before satisfying the five-year holding period or when their gain exceeds the §1202 exclusion cap
  - Under §1045, a taxpayer who has **held qualified small business stock for more than six months** may elect to defer recognition of gain by **reinvesting the sale proceeds in other QSBS within 60 days**
    - Section 1045 **does not eliminate the gain**; it merely **defers** it
    - **Holding period of the original stock is tacked onto the replacement stock for purposes of the §1202 five-year requirement**

Advanced Practice Issues
B. Section 1202 Qualified Small Business Stock – §1045 Rollovers

- **§1045 Rollovers – Interaction with §1202**
  - Section 1045 serves as a bridge to §1202
  - A taxpayer who sells QSBS before meeting the five-year holding requirement may defer the gain under §1045, invest in replacement QSBS and, once the combined holding period exceeds five years, permanently exclude the deferred gain under §1202 if the replacement stock otherwise qualifies
    - In addition, §1045 can be used to defer gain above the §1202 exclusion cap
    - For example, if a taxpayer sells QSBS after five years with a $15 million gain, only $10 million (or $15 million for post OBBBA stock) is excludable under §1202; the excess gain can be deferred by reinvesting that amount in replacement QSBS within 60 days
    - Each block of replacement stock has its own exclusion cap, allowing investors to repeat the process and potentially exclude multiple $10 million or $15 million gains over time

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Advanced Practice Issues

B. Section 1202 Qualified Small Business Stock – §1045 Rollovers

- **§1045 Rollovers – Mechanics**
- The mechanics are as follows:
  - Compute the gain realized on the sale of the old QSBS; then
  - Compute recognized gain, which is the realized proceeds less the old QSBS gain excluded under §1202 less the amount reinvested in new QSBS exclusion and the amount reinvested in new QSBS; and
  - Reduce basis in the replacement QSBS by the amount of gain computed in step 1 less the amount recognized in step 2

Advanced Practice Issues

B. Section 1202 Qualified Small Business Stock – §1045 Rollovers

- ***Example 8***
  - **Early sale and deferral** – In 2015, John buys QSBS for $1 million. After three years, in 2018, he sells the stock for $3 million
  - He reinvests the entire $3 million of proceeds in replacement QSBS within 60 days and makes a §1045 election
  - In 2022, he sells the replacement QSBS for $6 million. John's $2 million gain on the 2018 sale is deferred under §1045
  - Because the holding period of the original stock (2015–2018) is tacked onto the replacement stock, John is treated as having held the replacement stock for more than five years (2015–2022)
  - Accordingly, he may qualify for the §1202 exclusion on the deferred gain when he sells the replacement stock in 2022

Advanced Practice Issues

B. Section 1202 Qualified Small Business Stock – §1045 Rollovers

- ***Example 9***
  - **Early sale and partial deferral** – Bethany purchased stock in XYZ Corp (QSBS) in 2020 for $2M
  - In 2022, she sells the stock in XYZ Corp for $7M (§1202 holding period not met), and within 60 days, reinvests the $4M of proceeds in ABC Corp (QSBS) making a §1045 election on the reinvestment
  - Bethany's realized gain is $5M ($7M proceeds - $2M basis). Her recognized gain amounts to $3M ($7M proceeds - $0 §1202 excluded gain - $4M replacement cost of ABC Corp)
  - The basis of the replacement QSBS in ABC Corp is reduced by $2M ($5M realized gain less $3M recognized gain) and assumes basis in ABC Corp of $2M ($4M replacement cost – $2M basis reduction) rather than $4M

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Advanced Practice Issues

B. Section 1202 Qualified Small Business Stock – §1045 Rollovers

- ***Example 10***
  - **Exceeding the exclusion cap** – Lisa acquires QSBS in 2016 for $1 million and sells it in 2023 for $15 million, realizing a $14 million gain
  - Under §1202 (pre OBBBA), she may exclude $10 million of the gain
  - To defer the remaining $4 million, Lisa reinvests $4 million of the proceeds into new QSBS within 60 days and makes a §1045 election
  - After holding the replacement stock for two additional years (which, combined with the original holding period, satisfies the five-year requirement), she sells it for $6 million
  - Lisa may exclude the deferred $4 million gain under §1202 because the holding period of her original investment is tacked onto the replacement stock
  - The replacement investment also provides a new $10 million exclusion cap, allowing her to potentially exclude additional gains if the replacement stock appreciates

Advanced Practice Issues

B. Section 1202 Qualified Small Business Stock – §1045 Rollovers

- ***Example 11***
  - **Partnership Rollover** – Suppose a partnership holds QSBS, sells it and reinvests the proceeds in replacement QSBS within 60 days
  - The partnership can elect §1045 at the entity level. Alternatively, if the partnership fails to elect §1045, individual partners may still make the election on their personal returns for their share of the proceeds used to acquire replacement QSBS
  - However, a partner cannot defer gain when selling his or her partnership interest itself, even if the partnership owned only QSBS

- **Closing Thoughts**
  - Although OBBBA did not modify §1045 itself, the Act's enhancements to §1202, such as the increased $15 million per-issuer cap and the tiered 50/75/100 percent exclusions make §1045 even more valuable
  - Taxpayers can use §1045 to defer gain until they reach the three-, four- or five-year milestones necessary for partial or full exclusion under §1202 and can roll gains exceeding the new $15 million cap into additional QSBS for further exclusions
  - Thus, §1045 remains an important tool in the tax planner's arsenal when combined with the generous benefits of §1202 under the One Big Beautiful Bill Act

Decentralized Autonomous Organizations
Introduction

- The evolution of technology, particularly in the blockchain space, has introduced new ways of structuring organizations
- Decentralized Autonomous Organizations (DAOs) are at the forefront of this movement, revolutionizing the way businesses, nonprofits, and social groups are formed and managed
- Over the past five years, more than 10,000 DAOs have come into existence
- This marks a significant shift in how organizational structures are conceptualized and operated

Decentralized Autonomous Organizations
Introduction

- DAOs are organizations that operate primarily through automated algorithms and decentralized governance rather than traditional human-led management
- These organizations are powered by smart contracts and protocols that dictate how decisions are made, how resources are allocated, and how the entity is governed
- The rise of DAOs aligns closely with the broader push toward decentralization in the digital age, particularly within the context of Web3 and blockchain technologies

Decentralized Autonomous Organizations
Introduction

- A key feature of DAOs is their ability to reduce human interference in operational decision-making, thereby minimizing the risk of corruption and inefficiency
- Traditional organizations—whether businesses, nonprofits, or governments—often suffer from issues like gatekeeping, bureaucracy, and the manipulation of power by those in control
- In contrast, DAOs utilize automated, transparent systems to facilitate decision-making, ensuring that every action is recorded and verifiable on a public ledger, often a blockchain

Decentralized Autonomous Organizations
Introduction

- Interestingly, this concept of transparency contrasts sharply with the origins of cryptocurrency, which was initially rooted in ideals of privacy and autonomy from centralized institutions
- DAOs, while decentralized, embrace transparency as a means of ensuring trust and accountability
- This has led some to coin the term "**transparocurrency**" as a more appropriate descriptor for the type of financial and organizational structures DAOs represent

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Decentralized Autonomous Organizations
Understanding the Legal Landscape for DAOs

- Initially, DAOs were considered to exist outside traditional legal frameworks, and many early proponents believed that DAOs did not need to conform to the entity classifications used by most legal systems
- The decentralized and often anonymous nature of blockchain technology reinforced this belief, as DAOs could operate without a physical presence or centralized leadership
- However, as DAOs have proliferated, legal systems worldwide have begun to recognize their growing influence

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Decentralized Autonomous Organizations
Understanding the Legal Landscape for DAOs

- In the United States, for example, DAOs that are not registered as formal legal entities are typically treated as general partnerships
- This default classification exposes DAO members to significant risks, including unlimited personal liability for the actions of the DAO, which can be a major deterrent for participants
- This legal ambiguity has led many DAOs to seek formal recognition through the creation of "legal wrappers" that grant the organization legal standing, liability protection, and clearer tax treatment
  - These legal wrappers typically involve incorporating the DAO as a traditional legal entity such as a corporation, limited liability company (LLC), or nonprofit
  - By doing so, DAO founders and members can enjoy the benefits of limited liability, shielding themselves from personal responsibility for the actions of the DAO

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Decentralized Autonomous Organizations
Legal Entities for DAOs

- Selecting the appropriate legal entity for a DAO is a critical decision that can have far-reaching implications for its governance, tax obligations, and overall operational structure
- The choice of entity will largely depend on the DAO's purpose, its level of centralization, and whether it intends to generate taxable income
- Broadly speaking, DAOs can be categorized based on their intended purpose, and each category comes with its own set of legal considerations

Decentralized Autonomous Organizations
Legal Entities for DAOs

- There are four primary categories of DAOs and the legal structures commonly used for each (cont'd):
  1) **Charitable and Social Purpose DAOs (Nonprofits):**
     - DAOs established to pursue charitable, educational, or social missions often seek nonprofit status. Nonprofit DAOs may apply for tax-exempt status under relevant sections of the U.S. Internal Revenue Code, such as §501(c)(3) for charitable organizations or §501(c)(6) for trade associations
     - These entities must navigate strict regulations regarding their activities, income sources, and how funds are allocated to ensure compliance with their nonprofit tax standing

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Decentralized Autonomous Organizations
Legal Entities for DAOs

- There are four primary categories of DAOs and the legal structures commonly used for each (cont'd):

  2) **Shared Property or Collection DAOs:**
     - Many DAOs are created to manage shared assets, such as intellectual property, digital files, or even physical goods
     - In these cases, the legal structure must accommodate shared ownership and governance, often through the use of LLCs or cooperatives
     - This type of DAO allows multiple stakeholders to collaborate on managing assets, with decision-making typically handled through decentralized voting mechanisms

Decentralized Autonomous Organizations
Legal Entities for DAOs

- There are four primary categories of DAOs and the legal structures commonly used for each (cont'd):

3) **Governance or Protocol DAOs:**
   - Some DAOs are designed to manage decentralized networks, software protocols, or blockchain ecosystems
   - These governance-focused DAOs rely heavily on smart contracts and algorithms to automate decision-making processes
   - While these DAOs may not generate significant revenue, they still require a legal structure that provides liability protection and a clear governance framework. LLCs are often used in these cases, although some DAOs opt for more innovative legal structures that better reflect their decentralized nature

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Decentralized Autonomous Organizations
Legal Entities for DAOs

- There are four primary categories of DAOs and the legal structures commonly used for each (cont'd):
  4) **Investment DAOs:**
     - DAOs that pool resources for investment purposes operate similarly to traditional venture capital or investment funds
     - These DAOs may invest in a wide range of assets, including cryptocurrencies, real estate, and startups
     - Investment DAOs often form as corporations or LLCs, allowing for the distribution of profits to members while providing liability protection
     - In some cases, these DAOs may also explore international legal structures, depending on the jurisdictions in which they operate

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Decentralized Autonomous Organizations
The Legal Framework for DAOs in the United States

- The selection of the appropriate legal entity for a DAO also depends on its operational structure and goals
  - For example, a DAO created by multiple for-profit companies to manage shared software protocols might choose to incorporate as a joint venture LLC
  - This approach allows the DAO to hire employees, manage intellectual property, and allocate profits to members while limiting their liability
- In contrast, a DAO with a mix of commercial, nonprofit, and industry-specific goals might choose to "spin off" multiple DAOs to manage each aspect of its operations separately
  - This can help avoid the complications that arise when trying to combine diverse objectives within a single legal entity

Decentralized Autonomous Organizations
The Legal Framework for DAOs in the United States

- Several U.S. states have been at the forefront of developing legal frameworks that cater specifically to DAOs. These laws provide DAOs with the legal certainty they need to operate while maintaining their decentralized structure. Notable states include:
  - **Vermont (2018):** Vermont was the first state to introduce legislation that allowed LLCs to operate using blockchain technology
  - **Wyoming (2021):** In 2021, the state introduced a law that explicitly recognized DAOs as legal entities, known as DAO LLCs
  - **Tennessee (2022):** Tennessee passed its own DAO LLC law, which grants legal recognition to DAOs and provides a regulatory framework for their operation
  - **Utah (2023):** Utah's law is based on a model developed by the Coalition of Automated Legal Applications (COALA)
    - This model law is specifically designed for DAOs, and it allows them to operate as distinct legal entities with their own set of rules and protections

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Decentralized Autonomous Organizations
The Legal Framework for DAOs in the United States

- These state laws share a **common goal:** to provide DAOs with the legal certainty needed to operate in compliance with U.S. law
- However, these laws are not without their challenges
  - Some experts argue that the current legal frameworks impose unnecessary burdens on DAOs, such as disclosure requirements that may be difficult for decentralized organizations to meet
  - Others believe that the laws fail to address the complexities of reconciling smart contracts with traditional legal agreements

Decentralized Autonomous Organizations
The Evolution of DAO-Specific Legal Entities

- Laws modeled on the COALA framework provide DAOs with a distinct legal personality and offer limited liability protections
- Unlike earlier DAO LLC laws, which adapted existing LLC statutes for use by DAOs, the COALA model law is specifically designed for decentralized organizations
- The COALA model law addresses several key issues that have arisen in the context of DAOs, including how to handle contentious hard forks (situations where a blockchain splits into two competing chains) and how to manage cooperative upgrades to the DAO's governance protocols (known as "soft forks")
  - By providing clear guidelines for these scenarios, the COALA law offers DAOs a level of legal certainty that was previously lacking

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Decentralized Autonomous Organizations
The Evolution of DAO-Specific Legal Entities

- One of the most significant innovations in the COALA model law is its approach to resolving disputes that arise from hard forks
  - In the event of a contentious fork, the COALA law provides mechanisms for determining which version of the blockchain is the "majority chain," and therefore retains control over the DAO's assets
- This is crucial in ensuring that DAOs can navigate complex technical issues without losing their legal standing or facing lawsuits from disgruntled members
- The COALA model law also recognizes that DAOs often engage in a mix of commercial and non-commercial activities
  - This flexibility allows DAOs to pursue a wide range of objectives, from profit-making ventures to community-driven projects, without being constrained by rigid legal classifications

Decentralized Autonomous Organizations
The Future of DAOs and Legal Entities

- As DAOs continue to grow in scope and complexity, the need for robust legal frameworks that accommodate their unique characteristics will only increase
- The choice of legal entity is critical for any DAO, as it impacts everything from governance and liability to taxation and compliance
  - States like Wyoming, Vermont, and Utah are leading the way in developing laws tailored to the needs of DAOs, but these laws are still in their early stages
- In the coming years, DAO-specific legal entities will need to address common legal issues such as fiduciary duties, the business judgment rule, and the application of partnership or corporate tax regimes
- As DAOs continue to grow in complexity and scope, the legal frameworks surrounding them will need to evolve in tandem, providing both flexibility and certainty for these innovative new organizational structures

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Decentralized Autonomous Organizations
The Future of DAOs and Legal Entities

- One of the key challenges for DAOs moving forward will be navigating smart contracts
- While smart contracts offer significant advantages in terms of automation and transparency, they can also create legal ambiguities when conflicts arise
- DAO-specific legal frameworks will need to address these issues head-on, providing clear guidelines for how smart contracts should be treated in a court of law
- Another major challenge for DAOs is tax compliance
  - DAO-specific legal entities will need to provide clear guidance on how DAOs should be taxed, whether as partnerships, corporations, or some other legal entity

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Decentralized Autonomous Organizations
The Future of DAOs and Legal Entities

- As DAOs continue to push the boundaries of what is possible in terms of decentralized governance, they will need to find new ways to balance innovation with legal compliance
- DAO-specific legal frameworks will need to evolve in tandem with the technology, providing DAOs with the flexibility they need to grow while ensuring they remain compliant with state and federal laws
- DAOs represent a new frontier in organizational structure, and their continued growth will depend on the development of robust legal frameworks that can accommodate their unique needs
- As more states and countries recognize the potential of DAOs, we can expect to see even more innovative legal structures emerge, providing DAOs with the legal certainty they need to thrive in the digital age

Chapter 4

Stage 3 – The Final PIR Process for ASC Topic 842, *Leases*

Learning Objectives

- After completing this chapter, you should be familiar with the results and findings of the FASB's Final (Stage 3) Post-Implementation Review (PIR) Report on Topic 842

Objectives of the PIR Process

1. Determine whether ASC 841 is accomplishing its stated purpose
2. Evaluate the implementation and continuing compliance costs, as well as the benefits realized by various stakeholders, including preparers, investors, and regulators
3. Provide feedback to the standard-setting process

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Timeline of the PIR Process for ASC 606

- Stage 1
  - 2016: ASC 842 formally issued, beginning Stage 1 (despite deferral of effective dates)
- Stage 2
  - 2016–2025: Evaluated the actual costs and benefits of the standard post-implementation. During stage 2, which begins after the effective date of the final standard and continues for approximately three to five years, the FASB undertakes activities to:
    - Understand the costs that an entity incurred in applying the standard and understand the costs that investors and other users incurred in analyzing and interpreting the information in the standard
    - Understand the benefits of the standard to investors, entities, and other stakeholders
    - Monitor the ongoing application of the standard
- Stage 3
  - Final report issued after public meeting in November 2025

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Stakeholders Engaged

- The FASB used a multi-faceted approach to gather feedback. They conducted individual interviews and hosted group discussions. They organized advisory group meetings, public roundtables, and stakeholder surveys. They delivered webcasts and participated in conferences, and they solicited and reviewed comment letters in response to exposure drafts
  - **Investors** – Including buy-side and sell-side analysts, accounting analysts, credit rating agency professionals, lenders, and private equity firms
  - **Preparers** – Public and private companies, as well as not-for-profit entities, across a wide spectrum of industries and sizes
  - **Practitioners** – Representatives from audit and consulting firms at the international, national, and regional levels
  - **Other stakeholders** – Academics, state CPA societies, trade organizations, regulators, and other standard setters

Summary of Leases (Topic 842) PIR Results

- FASB determined that Topic 842 successfully met its primary goal of recognizing lease assets and liabilities on lessees' balance sheets, enhancing visibility of lease obligations
- Stakeholder feedback was mixed
  - Investors and other users generally agree they now receive more decision-useful information about companies' leasing activities
  - For lessees, the cost and complexity of implementation were significantly higher than initially expected by the FASB due to unanticipated system and process overhauls
  - Lessors' experience was smoother, with minimal implementation effort needed because lessor accounting changed only modestly from prior GAAP

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Significance of Implementation Costs – Lessees

- Implementing the new lessee accounting requirements entailed substantial one-time and ongoing costs
- Preparers report that initial adoption costs were significantly higher than the FASB anticipated, and continuing compliance remains costly
- Key cost drivers:
  - **System upgrades and software** – Most companies discovered their existing IT systems couldn't handle the new standard's demands, especially the need to track operating leases on the balance sheet. This led to purchasing new lease accounting software or heavily modifying systems. Many entities also needed to develop processes for amortizing right-of-use assets for operating leases, a concept that didn't exist under prior GAAP
  - **Comprehensive contract reviews** – Implementing Topic 842 required identifying all arrangements that contain a lease, including embedded leases, which were often difficult and costly to identify. Many lessees undertook painstaking reviews of contracts (real estate, equipment, service agreements, etc.) to find embedded leases and gather data on lease terms

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Significance of Implementation Costs – Lessees

- Key cost drivers (continued):
  - **Data capture and entry** – Companies had to extract lease terms (payments, duration, renewal/termination options, etc.) from contracts and input them into new systems
    - Ensuring completeness and accuracy of lease data demanded significant time and effort from accounting teams and consultants
  - **Increased staffing and training** – Preparers often needed to hire additional staff or consultants specialized in lease accounting. Existing employees required training on Topic 842. Firms also incurred higher audit fees, as auditors spent more time reviewing lease implementations
  - **Ongoing compliance** – Even after adoption, lessees face higher ongoing costs for maintaining lease inventories, updating for modifications, and generating enhanced disclosures each period
    - These recurring costs (e.g., software maintenance and internal controls) have generally been higher than the Board's original expectations for post-implementation compliance

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Significance of Implementation Costs – Lessors

- Costs for lessors to implement and comply with Topic 842 have been low because Topic 842 largely retained the prior lease accounting model for lessors
  - **Little systems overhaul needed** – Lessor systems and processes for lease accounting (e.g., recognize lease receivables, perform lease classification) remained largely unchanged, avoiding significant new costs
  - **Targeted improvements only** – The FASB issued a few narrow updates for lessors (for example, eliminating leveraged lease accounting and aligning revenue recognition timing). These tweaks were not cost-intensive, and the Board provided transition relief where needed

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Biggest 7 Challenges (in Order) for Lessees in Applying Topic 842

1. **Determining the discount rate** – Lessees must record lease liabilities at the present value of lease payments, which requires selecting an appropriate discount rate (incremental borrowing rate or the rate implicit in the lease). Private companies got relief by being allowed to use a risk-free rate, but for many lessees, especially public companies, estimating the correct discount rate for each lease was a complex and judgmental task that gained new scrutiny once lease liabilities were on the balance sheet
2. **Recognition and measurement** – Lessees struggled with the appropriate recognition of shipping costs, installation costs, ROU impairments, accounting for lease incentives, and the interaction of the requirements with business combination accounting under other standards. The FASB noted that these challenges were higher in the initial adoption period and have decreased over time
3. **Related parties** – Under ASC 842, **related party leases are treated the same as all other lease arrangements**. There is no separate guidance except for leases under common control arrangements (ASU 2023-01). The common control arrangements presented the biggest challenge for related party leases, which led to the issuance of the ASU

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Biggest 7 Challenges (in Order) for Lessees in Applying Topic 842

4. **Lease modifications and remeasurements** – The accounting for lease modifications (changes in lease scope or consideration) under Topic 842 can be complex. Depending on the nature of the change, a modification might be treated as a separate new lease or a remeasurement of the existing lease. Stakeholders reported difficulty applying the modification guidance, which often requires significant judgment and can affect multiple balances. This area was a notable change from legacy GAAP and required careful analysis

5. **Identifying *all* lease arrangements, with a focus on embedded leases** – Because Topic 842 requires bringing operating leases onto the balance sheet, companies had to scrutinize contracts enterprise-wide. Determining whether an arrangement "contains a lease" became a routine process. Lessees had to evaluate service agreements, supply contracts, and other agreements to find embedded leases (identified assets with control by the customer). This was more challenging than under prior rules, as previously many operating leases were just disclosed and not systematically tracked

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Biggest 7 Challenges (in Order) for Lessees in Applying Topic 842

6. **Sale-and-leaseback transactions, including built-to-suit arrangements** – Topic 842 implemented new rules for sale-leaseback (where an asset is sold and then leased back by the seller). These rules focus on establishing that a *true sale* has occurred under revenue recognition guidance. Preparers found the sale-leaseback guidance challenging, as it changed prior practice and required analyzing whether control of the asset transfers to the buyer/lessor. Determining if a sale took place (and when to recognize gain/loss) introduced complexity in these transactions. Under previous GAAP, "build-to-suit" leases had unique guidance. Topic 842 removed some of that and aligned more with the new control model, but accounting for unique or complex arrangements (like build-to-suit) still requires significant judgment. Lessees mentioned these areas as tough to navigate, although they are relatively niche

Biggest 7 Challenges (in Order) for Lessees in Applying Topic 842

7. **Allocating between lease and nonlease components** – Contracts often bundle lease components (right to use an asset) with nonlease components (services or maintenance). Under Topic 842, lessees must separate lease components from service components to account for each appropriately (unless a practical expedient to combine is elected). Determining that split for each contract (and whether a contract even *contains* a lease) proved difficult and time-consuming for many companies

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What Is Next for the Lessee Challenges?

- Despite these challenges, it's important to note that many difficulties were mitigated over time through FASB staff guidance, new ASUs, and companies' growing experience
- The FASB's PIR found that no fundamental changes to the lessee model are deemed necessary now
  - *Stakeholders prefer not to overhaul the standard again*
- However, private company constituents continue to seek practical expedients or simplifications to ease ongoing compliance burdens (e.g., simpler discount rate options), indicating some challenges persist for smaller entities

Three Minor Lessor Challenges

1. **Recognition and measurement** – Despite minimal changes to lessor accounting, lessors still reported the most difficulties with recognition and measurement, particularly as it relates to sales taxes and other similar taxes collected as part of the lease transaction. The FASB responded by allowing lessors to make an election to skip the evaluation of such taxes altogether and not account for those taxes as lessor costs
2. **Allocating between lease and nonlease components** – Aligning lessor accounting with the revenue recognition model (Topic 606) led to some initial confusion, for example, how to handle certain variable payments or classification criteria differences
3. **Interaction with Topic 606 and Topic 610** – Minor issues

Key Benefits Observed From Implementing Topic 842

- **Increased balance sheet transparency for investors** – The *primary benefit* of Topic 842 is that it (largely) ended the widespread off-balance sheet accounting for leases
  - Virtually all leases (other than short-term leases) now result in a right-of-use asset and lease liability on the balance sheet, whereas under legacy GAAP operating leases were invisible on the balance sheet
  - This gives investors and lenders a more faithful representation of a company's financial position regarding leased assets and obligations. Investors have better data to analyze leverage and obligations. For instance, they no longer must estimate lease liabilities from footnote disclosures, improving comparability across companies and industries

Key Benefits Observed From Implementing Topic 842

- **Enhanced disclosures and visibility of lease commitments** – Stakeholders broadly agree that qualitative and quantitative disclosures about leasing improved under Topic 842. The standard introduced new disclosure requirements (e.g., weighted-average lease term, discount rate, maturity analysis of lease obligations, and information about lease variable payments and options)
- Investors commented that these disclosures are a notable improvement over the boilerplate or minimal disclosures under old rules, giving deeper insight into companies' leasing arrangements
  - For example, the PIR cites that "*almost all investors agree that the disclosures provided under Topic 842 are an improvement to those provided under legacy GAAP*"

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Key Benefits Observed From Implementing Topic 842

- **Improved internal controls and lease management** – Many preparers (lessees) reported an unintended but positive consequence of implementing Topic 842 – it forced a thorough inventory of lease contracts and better cross-functional processes. By having to identify and quantify all leases, companies often discovered contract management weaknesses and subsequently strengthened internal controls around leasing and procurement
- Organizations established new procedures to ensure completeness of lease recording and to monitor lease changes, which in many cases improved governance over contracts
  - Lessees gained better visibility into their lease portfolios and exposures, which is beneficial for management and auditors beyond just financial reporting compliance

Key Benefits Observed From Implementing Topic 842

- **Greater comparability of financial statements** – Bringing leases on the balance sheet enhances comparability between companies that lease assets and those that borrow to buy assets. Under legacy GAAP, a company heavily using operating leases appeared less leveraged than a company owning assets with debt, even if the economic position was similar
  - Now, the playing field is more level, as lease liabilities are visible and can be compared or combined with debt obligations to assess true leverage
- **This benefit was a key objective stated by FASB (improving understanding of commitments regardless of financing method), and PIR feedback indicates this goal was achieved**

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Key Benefits Observed From Implementing Topic 842

- **Alignment for lessors with revenue recognition** – Although lessor accounting didn’t drastically change, one benefit of Topic 842 was better alignment of lessor guidance with the new revenue recognition standard (ASC 606)
- The PIR notes that Topic 842’s lessor provisions were brought closer in line with the concepts of control and revenue recognition
  - For example, the definition of a lease and certain classification criteria were adjusted to mirror revenue principles
- Stakeholders see this as a benefit because it reduces conceptual inconsistencies and is especially helpful when companies are both sellers and lessors (like manufacturers leasing their equipment)

Key Benefits Observed From Implementing Topic 842

- **Preservation of relevant information for lessors** – Investors generally remain satisfied with the information provided by lessors under Topic 842. Key metrics (lease income, residual values, etc.) are still reported in ways similar to before, meaning useful trend information was preserved, while incremental improvements (like additional disclosures on lessors' exposure to risks) were added
- In essence, lessors kept the familiar reporting (no loss of decision-useful info) and gained some alignment benefits, which was in line with what the Board intended.

Expected vs. Actual Outcomes: Lessees vs. Lessors

	Lessees – Expected (FASB's assumptions)	Lessees – Actual Outcome (PIR findings)	Lessors – Expected (FASB's assumptions)	Lessors – Actual Outcome (PIR findings)
Implementation Costs	*Moderate* incremental costs. Many companies anticipated using existing systems and processes from legacy GAAP; once initial setup was done, ongoing compliance costs would be only slightly higher than under old lease rules.	Significantly higher than expected. Widespread system limitations forced most lessees to purchase new software or overhaul processes. Substantial effort to identify all leases and inputs led to much greater one-time and ongoing costs than the Board envisioned. Many firms needed extra staff/consultants and continue to incur higher compliance costs annually.	*Minimal* changes needed. Because Topic 842 left most lessor accounting unchanged, the Board expected little cost impact for lessors. Preparers and the FASB assumed legacy systems and methods could handle the new standard with negligible effort or expense.	Minimal costs realized, as expected. Most lessors did not incur significant costs to implement or comply. Systems and processes were indeed adequate. The only investments were minor updates (for targeted amendments aligning with revenue recognition), which were not costly.

Expected vs. Actual Outcomes: Lessees vs. Lessors

	Lessees – Expected (FASB's assumptions)	Lessees – Actual Outcome (PIR findings)	Lessors – Expected (FASB's assumptions)	Lessors – Actual Outcome (PIR findings)
Key Challenges	*(Anticipated as low)* – FASB did not fully expect major operational challenges since lessee concepts (e.g., lease classification, lease term, etc.) were similar to old GAAP, and stakeholders downplayed implementation difficulty during development.	Numerous challenges emerged. Lessees faced unforeseen complexity in gathering complete lease data, applying new judgments (discount rates, options), and updating controls. The PIR found a "significant gap" between what preparers thought would be needed and the real-world complexity, especially in contract reviews, component separation, and lease modifications.	*(Anticipated as low)* – With no fundamental changes to the lessor model, the Board foresaw few challenges for lessors. Any issues would likely be minor clarifications, given alignment efforts with Topic 606 and removal of outdated concepts like leveraged leases.	Few challenges in practice. Lessor feedback confirmed no significant ongoing issues in applying 842. A few lessors requested fixes (e.g., for sales-type lease definitions, handling certain variable payments), which FASB addressed through small improvements, but overall, the lessor model was operational as intended.

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Expected vs. Actual Outcomes: Lessees vs. Lessors

	Lessees – Expected (FASB's assumptions)	Lessees – Actual Outcome (PIR findings)	Lessors – Expected (FASB's assumptions)	Lessors – Actual Outcome (PIR findings)
Benefits of New Standard	Greater transparency and comparability from on-balance-sheet leases; improved lease disclosures; better insight into lease obligations for investors and creditors; closer alignment between lease accounting and the economics of transactions (fewer structuring opportunities). Also expected: stronger internal controls as companies formalize lease processes (acknowledged qualitatively in basis for conclusions).	Key benefits achieved. Investors report more useful information on lessee finances (lease liabilities now visible) and generally affirm that Topic 842's disclosures and balance sheet recognition met their needs. Preparers and auditors note improved internal lease controls and awareness. Some investors had mixed views on the *magnitude* of benefits, but *almost all agree disclosures are better than before*. Overall, benefits realized match those intended, with no major benefits gap identified in PIR.	Preserve useful info from legacy GAAP while aligning with new revenue standard; give users additional details on lessors' leasing risks; minimal disruption to lessor financial reporting.	Outcome met expectations. Investors are satisfied with lessor information under 842, indicating that the standard maintained decision-useful data for lessors. The intended alignment with revenue guidance was accomplished, and users received some incremental disclosures about lessors' exposure to risk, without unexpected consequences. Benefits for the lessor side were essentially "as expected" in the PIR findings.

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PIR Conclusions and Next Steps

- The post-implementation review of Topic 842 validates that the lease standard successfully addressed the core problem of off-balance sheet financing through lease accounting, providing more faithful representation of lease obligations and useful information to investors
- Experienced CPAs should recognize that, despite initial hurdles, the standard has led to better financial reporting outcomes and improved internal practices around leases
- The FASB has noted that no immediate standard-setting changes to Topic 842 are warranted as a result of the PIR
  - Partially because the FASB has issued clarifying ASUs since initial implementation

PIR Conclusions and Next Steps

- Board will continue to monitor feedback, particularly on reducing ongoing compliance costs for lessees (for instance, through the Private Company Council for smaller entities)
- Future standard-setting projects will also incorporate lessons learned from this PIR, such as the importance of thoroughly assessing system readiness and transition complexity during the development of major standards

Thank you!

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