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AICPA Revises Proposed Independence Interpretation for Governments

Last year, we reported on the proposed ethics interpretation from the Professional Ethics Executive Committee (PEEC) of the AICPA, *State and Local Government Entities*, which would revise the guidance in ET 1.224.020. (See "AICPA Proposes Independence Interpretations for Governments," in the June 2018 issue of this newsletter.) The objective of the proposal was to broaden independence considerations for auditors of state and local governmental entities, such as component units, funds, and certain investments. Over the comment period, PEEC received 23 letters, many of which requested further clarification of certain concepts. As a result, PEEC made revisions and re-exposed the proposed interpretation on January 11, 2019, with comments due March 11, 2019.

Practical Consideration:

The proposed interpretation, *State and Local Client Affiliates (formerly* Entities Included in State and Local Government Financial Statements) (ET 1.224.020) is available to Checkpoint subscribers at **riacheckpoint.com**, under "Advanced and Proposed Documents" in the "AICPA Professional Standards" section.

Substantive Revisions

The re-exposed interpretation notes three substantive revisions. First, it is noted that the original draft states that the *Conceptual Framework for Independence* should be consulted for certain upstream entities of an attest client. Commenters noted a cost-benefit issue with meeting this requirement for all upstream entities. As a result, PEEC replaced this requirement

In this Issue:

- AICPA Revises Proposed Independence Interpretation for Governments
- *Wayfair vs. South Dakota:* Show Me the Money!
- GASB's Planned Activities for 2019

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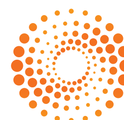

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with examples of relationships or circumstances that could lead the practitioner to consult the *Conceptual Framework for Independence*.

Next, the original proposed guidance stated that practitioners must "expend best efforts" to gather information necessary to identify all *investments* held by an attest client. PEEC expanded this requirement to state that such efforts should also be applied to identify all *affiliates* in the new exposure draft.

Finally, it was noted that the original requirement to presume that the attest client can exercise "more than minimal" influence over an entity when determining whether said entity is an affiliate was overly broad. PEEC ultimately decided that this presumption is more likely to be applicable for funds and blended component units, but less so for discretely presented components. Therefore, this proposed guidance has been revised to state that the presumption of "more than minimal" influence is to be made for funds and blended component units; however, discretely presented component units would need to be evaluated on a case-by-case basis.

Other Clarifications

The most significant clarification relates to the evaluation of downstream entities. The proposed interpretation requires that auditors remain independent of investments that the attest client controls and material investments over which the attest client has significant influence. The revised proposal further clarifies that auditors are not required to evaluate investments of all downstream entities. They are to evaluate the investments of the attest client itself, as well as those of any other entities included in the financial statements of the attest client—unless making reference to another auditor's report—when determining whether an investment is an affiliate.

Another clarification is made regarding determining materiality. A new paragraph is added to clarify that for purposes of this interpretation, materiality is to be applied based on the attest client's financial reporting entity as a whole, not for individual opinion units. It also reminds auditors to consider both quantitative and qualitative factors and use professional judgment when determining materiality.

There are several important terminology changes. First, the terms *upstream* and *downstream* have been removed from the text of the actual interpretation. However, the terms are still used in the introductory discussion and the overall concepts still apply. The term *primary government* used in the initial proposal differed from the GASB definition and is therefore replaced with *affiliate* and *entity*. In addition, the term *de minimis* was used in the original exposure draft, but commenters requested clarification. In response, PEEC replaced *de minimis* with the terms *trivial* and *clearly inconsequential*, both of which are defined in AU-C 450, *Evaluation of Misstatements Identified During the Audit*.

Effective Date

The initial proposal indicated the interpretation would be effective for engagements covering periods beginning on or after June 15, 2019, with early implementation allowed. However, the revised draft states that PEEC believes practitioners will need more time to implement and suggests that the effective date be one year after adoption, with early implementation still permitted.

Wayfair vs. South Dakota: Show Me the Money!

Over the past couple of decades, the new kid on the block—e-commerce—completely changed how the retail industry operated. In this new paradigm, a retailer could set up a new business website and be selling products and services throughout the United States on literally the same day. And the added bonus? The retailer only had to pay taxes on revenues generated from the state that the business was physically located in.

For the retailers, this practice cut down on paperwork and compliance issues related to paying taxes to every state where a sale was made and made for more competitive pricing compared to brick and mortar retailers that had to pay sales taxes. But, according to a 2017 United States Government Accountability Office (GAO) report, this practice made state and local governments miss out on approximately $8–$13 billion annually in state and local sales tax revenue. On June 21, 2018, the

Supreme Court decided this antiquated tax ruling was unfair, causing state and local governments to rejoice and tell online retailers to "Show me the money!"

Changing Tax Rules for Changing Times

Interstate commerce is not new. But we can all agree that the number of transactions and the financial impact of interstate commerce look totally different than they did in 1992, the last time the Supreme Court ruled on interstate taxation prior to overturning that ruling in 2018. At its core, the change in the tax rules relate to defining what constitutes a *sales tax nexus*, an activity in a state that requires a retailer to remit sales tax. Priorly, the Supreme Court ruled in *Quill Corporation vs. North Dakota* (1992) that a business must have a physical presence in the state, such as a store, office, employee, affiliate, or warehouse, to have a sales tax nexus in a state. However, this decision was overturned in 2018 in *Wayfair vs. South Dakota* when the Court ruled that a physical presence in a state is not required and that a business must only have a considerable amount of business in a state or an economic presence there to have a sales tax nexus, or more specifically an economic nexus. But what constitutes *economic presence*? The simple answer: it depends on the state.

E-commerce Nexus Laws by State

Prior to this new ruling, some states already had nexus laws in place, such as click-through nexuses, cookie nexuses, affiliate nexuses, marketplace nexuses, and use tax notice and reporting requirements, to combat the lost sales tax revenue. However, their use has not been as widespread as the use of this new economic presence nexus. A majority of states now have economic nexus laws in place. While there is no consensus among the states on defining economic presence, many states consider businesses with sales of at least $100,000 or 200 or more separate transactions to have an economic presence in a state. The effective dates vary as well, from January 1, 2016, to January 1, 2019. While the Supreme Court has decided that economic nexus should be decided by individual states, Congress is not leaving it at that.

Congress Says: Not So Fast

Congress is not completely on board with the Supreme Court's decision. Since the landmark case was settled, Congress is considering the following six federal bills related to the case:

- H.R. 6724, *Protecting Businesses from Burdensome Compliance Cost Act of 2018*—This bill would prevent the collection of tax from remote sellers.
- H.R. 6824, *Online Sales and Simplicity Small Business Relief Act of 2018*—This bill would prevent the collection of tax from remote sellers (maximum $10 million in gross annual receipts) and restrict the period to 2019 and later sales.
- H.R. 7184, *No Retroactive Online Taxation Act of 2018*—To prohibit a state from collecting retroactive sales tax for sales that occurred before June 21, 2018, from remote sellers.
- S.3180, *Stop Taxing Our Potential Act of 2018*—This bill would prevent the collection of tax from retailers that did not have a physical presence in the jurisdiction.
- S.3581, *Digital Goods and Services Tax Fairness Act of 2018*—This would restrict taxes on the sale or use of digital goods and services.
- S.3725, *Online Sales and Simplicity Small Business Relief Act of 2018*—This bill would prevent the collection of tax from remote sellers (maximum $10 million in gross annual receipts) and restrict the period to 2019 and later sales.

Current Status

Each of these bills has been referred to its respective committee. But with no estimated effective date or resolution in sight related to these bills, some people are skeptical about the likelihood of Congress passing any of them, which leaves the Supreme Court ruling in control.

Many states are still trying to figure out how to implement this new guidance without putting undue pressure on businesses. Some states have organized a Streamlined Tax Registration System, while others are offering amnesty and the option to use voluntary disclosure agreements.

Practical Consideration:

Educate yourself on this breaking issue and discuss potential outcomes with your clients. Continue to check state Department of Revenue sites for new developments in each state.

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GASB's Planned Activities for 2019

Similar to other standard-setting bodies, it looks like it will be another busy year for the Governmental Accounting Standards Board (GASB). If you have been following the Financial Accounting Standards Board or the International Accounting Standards Board, many of the topics will sound familiar, among them: leases, debt, revenue recognition, and financial statement disclosures. Other topics were initiated based on input from stakeholders in the governmental financial reporting community. Following is what the GASB has planned for 2019 at this point.

Exposure Drafts

The GASB expects to issue three exposure drafts for comment during 2019 on the following topics:

- Accounting for subscription-based IT arrangements, such as cloud computing
- Public/private partnerships
- Implementation guide for leasing arrangements

Implementation Guides

The GASB is planning to issue in final form the following two implementation guides:

- Annual Update
- Fiduciary Activities

Final Statements

Look for a final statement to be issued in May on conduit debt.

Other Projects

In March, the GASB has two User Forums and three Public Hearings scheduled for the proposals on the Financial Reporting Model and Recognition Concepts.

Deliberations will continue in 2019 on the Revenue and Expense Recognition project, with the GASB expecting to select a model early in the year. A Preliminary Views document is scheduled for next year. In addition, deliberations will continue on the Disclosure Framework project, including footnotes, with a Preliminary Views also scheduled for 2020.

New Practice Issues Added to the Technical Agenda

Several new practice issues were added, primarily based on stakeholder input on the following topics:

- Deferred compensation plans
- Secured Overnight Financing Rate, which will replace LIBOR and will include derivatives and interest rate swaps
- Omnibus Project

Practical Consideration:

You can keep yourself up to date on the GASB activities by accessing **www.gasb.org** and selecting the "Projects" page.