12:45 – 1:45 p.m.

Cryptocurrency Taxes: Implications, Planning & Strategies

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Crypto Tax Deep Dive

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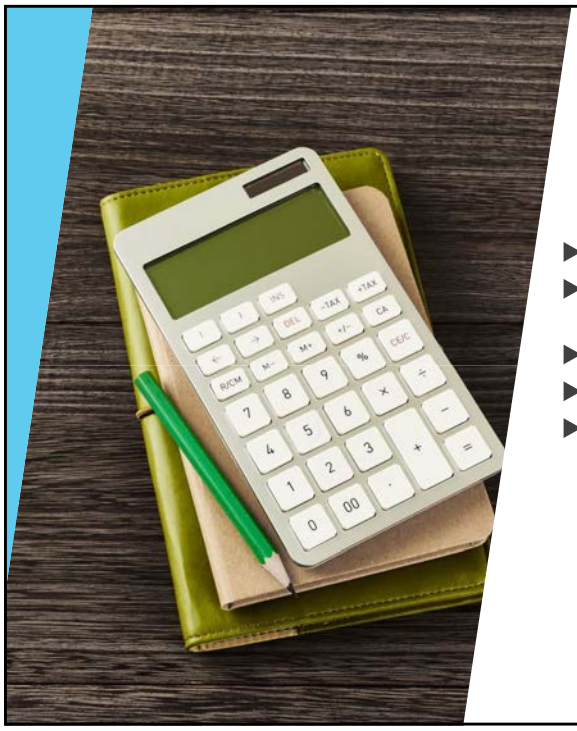
About me

- Dr. Sean Stein Smith, CPA, CMA, CGMA, CFE
- Assistant Professor, Lehman College, City University of New York
- Forbes Contributor – Crypto & Blockchain
- AICPA Outstanding CPA of the Year (2022)
- Accounting Today Top 100 Most Influential People in Accounting
- E.C. Harwood Visiting Research Follow – American Institute of Economic Research
- Board of Advisors – Wall Street Blockchain Alliance (WSBA)
- Chair, Accounting Working Group, WSBA
- Advisory Board Member – Gilded "Crypto Accounting Made Simple"
- Strategic Advisor – Crescent City Capital
- 40 under 40 in Accounting (2017-2021)
- NJCPA Trustee (2022 FY)



Agenda

- Quick market update & FAQs
- Decentralized Finance (DeFi) activities
- Non-fungible tokens
- Stablecoins
- Taxes and organizational implications

Market update

Agenda

- U.S. GAAP cryptoasset update and open items
  - Implications for organizations holding/using crypto
- Federal and state crypto update
  - Tax planning implications
- Corporate Transparency Act
  - Introduction & overview

Ethereum merge, recap.

- The Ethereum merge has successfully been completed (September 2022)
  - Ethereum blockchain has converted from Proof-of-Work consensus to Proof-of-Stake consensus
  - Energy consumption will decline by approximately 99% as a result
  - Opens the door for further pivoting away from BTC to ETH as crypto market leader
- Tax accounting has not changed
  - More on that later
- Financial accounting has not changed
  - Not yet at least

Is ether a security?

- Same day as ETH merge completing, SEC chair Gary Gensler offered testimony that staked crypto could qualify as securities
- Meet criteria of the Howey Test as an “investment contract”
- https://cointelegraph.com/news/ether-staking-could-trigger-securities-laws-gensler

ETHPoW Fork?

- Speculated to possibly cause some issues with regards to the appetite/market post-merge
- Appealed to PoW miners looking to remain in business
- Token crashed up to 75% at worst declines following the merge
  - (24-36 hours after)
- Is showing signs of gaining popularity with some non-U.S. mining pools, etc.
- https://cointelegraph.com/news/does-ethereum-s-new-ethpow-fork-stand-a-chance-ethw-price-falls-65-post-merge
- https://news.bitcoin.com/new-ethereum-pow-fork-gathers-60-terahash-from-well-known-pools-ethws-price-shudders-39-in-24-hours/
- https://decrypt.co/110023/ethereum-fork-ethpow-suffers-bridge-replay-exploit-token-tanks-37

SEC Crypto Asset Office – Sept 2022

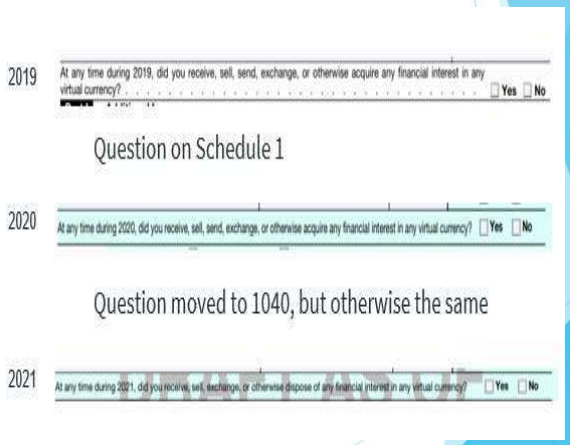
- Office of Crypto Assets will join the seven (7) existing offices that handle corporate disclosure filings
- https://www.reuters.com/markets/us/us-sec-set-up-new-office-crypto-filings-2022-09-09/
- *Office of Crypto Assets*
- The Office of Crypto Assets will continue the work currently performed across the DRP to review filings involving crypto assets. Assigning companies and filings to one office will enable the DRP to better focus its resources and expertise to address the unique and evolving filing review issues related to crypto assets.
- https://www.sec.gov/news/press-release/2022-158

Crypto Tax Focus

Everyone ready?

The 1040 Crypto Question

- Question about crypto involvement is still on the 1040, but now the language has been tweaked to include "disposed of" in the question itself
- Basically the question is now focusing on the transactions themselves versus the taxability of those transactions
- Transparency is key



FBAR requirement?

- FinCEN has been going back and forth on this issue, but what exactly are we talking about?
- No requirement to report crypto held in overseas wallets – at this time
- Lots of debate over
- 1) Whether crypto will have to be reported via an FBAR at all
- 2) What is the cut-off level for this reporting ($10,000, or something else)
- 3) Who has to report these items?
- https://tokentax.co/blog/how-to-file-a-crypto-fbar/
- https://www.natlawreview.com/article/fincen-seeks-to-establish-fbar-requirement-cryptocurrency-accounts-2021

What about FATCA? (Form 8938)

- What about it?
- Threshold for reporting (single filer) is if
- 1) total value of foreign assets exceed $50,000 as of last day of tax year
- 2) total value is above $75,000 at any point during the year
- You might have a FBAR filing requirement without FATCA, but if you file FATCA you are almost guaranteed to have an FBAR requirement
- As with everything else, a lot of uncertainty

Bipartisan Infrastructure Bill

- This bill passed in November 2021
- One minor clause now includes a change to how crypto is treated
  - Under this change, crypto is now treated as the equivalent as cash
  - Just for Section 6050I
- Any trade or business that receives $10,000 or more in physical currency (now including crypto) has significant reporting requirements
  - Including Form 8300
- All brokers will have to file 1099 and declarations
- https://www.wsj.com/articles/bitcoin-like-cash-crypto-currency-digital-assets-sect-60501-tax-code-infrastructure-bill-mchenry-ryan-11642449658

But there is more

- Major concern was that miners, coders, stakers, and other developers would be lumped in as “brokers”
- Treasury came out (Spring 2022) and said that would not be the case
- No official ruling from the IRS as of yet
- https://www.theblockcrypto.com/post/134039/us-treasury-reiterates-that-the-irs-wont-consider-crypto-miners-stakers-or-coders-to-be-brokers
- Will also impact DeFi (more on that later)

Jarrett vs. United States

- Nothing has changed as a result of these headlines
- Trial itself is only scheduled for 2023
- Evidence gathering has just started (March 2022)
- No change to IRS guidance or FAQs
- No indication that policy changes are coming
- Conversation specific to the unique facts and circumstances of this case and complaints therein
- https://www.natlawreview.com/article/recent-tax-developments-concerning-staking-rewards

Reporting crypto taxable income

- Crypto income and earnings are taxable, no matter what reddit or Instagram experts say
- Capital gains and losses should be reported on form 8949
  - IRS cross checks disclosure question with form 8949
- Those gains/losses flow through to Schedule D
- Mining income is generally considered ordinary income
- Paying/being paid in crypto should be reported at FMV at the date of payment

Erroneous tax data

- Repurposing 1099-B's have been put forward as the solution to produce more crypto tax data
- Not a perfect solution
- Crypto exchanges do not always have basis data
- Interoperability and cross-chain applications can make traditional reporting more complicated
- https://www.coindesk.com/layer2/taxweek/2022/02/23/form-1099-b-is-not-the-solution-to-your-cryptocurrency-tax-problems/

Stablecoin

Are these taxable or what?

Stablecoin breakdown

- Have a market capitalization well in excess of $150 billion USD
- Used for transactional purposes, and play an integral role in the DeFi economic landscape
- Issued by private organizations and are pegged to external assets
  - Fiat currencies
  - External assets (gold/oil)
  - Other cryptocurrencies
- But, are they taxable?

Stablecoin taxes?

- Stablecoins are treated the exact same way as other cryptoassets
- When used for purchases or paying for goods and services these cryptoassets must be disclosed, reported, and have any applicable taxes paid based on these transactions
- Only primary upside is
  - Lack of volatility means the tax obligations will be limited
  - Authorization by major players means that reporting/disclosure is more consistent and understandable
- Who is involved?

Does this matter?

Cryptocurrency is talked about a lot, but does it actually matter for you and your clients

Now or in the future?

Yes!

Coinbase has 80 million users worldwide, with nearly 3 million trading daily

As per most recent filings

Do these sound familiar?

- PayPal – 361 million users
- Visa – over 1 billion accounts worldwide
- Mastercard – over 700 million accounts worldwide
- Venmo – over 50 million monthly users
- CashApp – over 30 million monthly users
- They all allow crypto transactions
- Does it matter now?

Decentralized Finance

What is DeFi?

- New name and term for what was called “open finance”
- An umbrella term for a suite of blockchain projects and initiatives
- Runs primarily on Ethereum or Ethereum-based blockchains
- Increased reliance on smart contracts
- Capitalization of DeFi market grown from $686 million in Jan 2020
- Over $15 billion in Jan 2021
- Still $170 billion by Q3 2022
- https://news.bitcoin.com/total-value-locked-in-defi-reaches-250-billion-uniswap-quickswap-trader-joe-dominate-dex-volumes/#:~:text=The%20total%20value%20locked%20(TVL)%20in%20defi%20has%20reached%20an,value%20has%20expanded%20by%2025%25.

DeFi applications

- Decentralized exchanges (DEX)
- Stablecoins
- Crypto lending programs
- Wrapped bitcoins
- Prediction markets
- Yield farming
- Liquidity mining
- Composability
- Money legos

DeFi Tax Focus

- Staking
- Block rewards
- DeFi lending and liquidity pools
- Wrapped tokens
- Crypto loans and borrowing

Staking

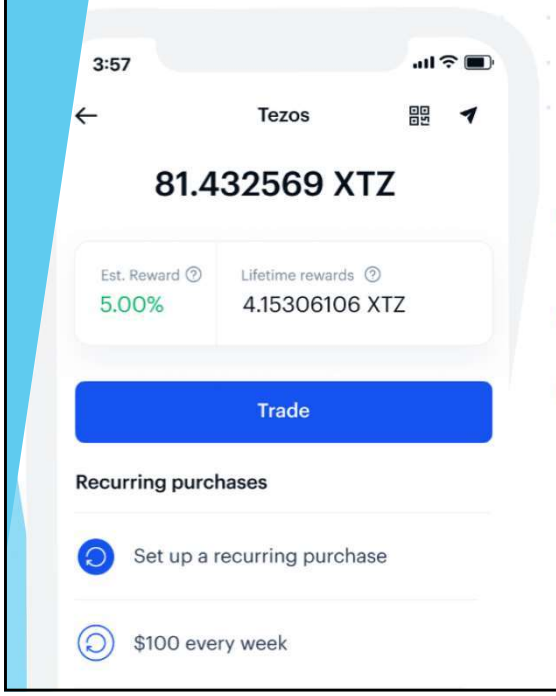
- Staking is a complicated issue that can vary depending on the investors and platforms involved
- Generally conducted as a way for investors to earn rewards for holding/investing into certain cryptocurrencies
- Crypto becomes part of a staking pool, and is utilized by the blockchain protocol for Proof-of-Stake consensus validation
- Allows taxpayers to earn crypto denominated income in a passive way
- Almost always involves a vesting or lock-up period where crypto is inaccessible

Staking taxes

- Is staking treated as ordinary income? No hard and fast answer as of yet
- Numerous lawsuits and arguments on this issue
  - Including the Jarrett v United States
- Congressional Blockchain Caucus also arguing for clearer and consistent regulation
- Also need to answer whether this meets the criteria of a trade or business?

Different crypto staking

- First question to ask is what kind of crypto staking arrangement is actually being used
  - Are the cryptos that are "locked" actually being used to validate transactions
  - Or is the arrangement move of a yield-generation one
- Actually running the node might be considered an active trade
  - Normally referred to as a validator versus a staker
- Delegated staking (usual type) is unlikely to be active



How widespread is it?

- What are the odds you have clients that are involved in crypto staking?
- Is it easy to get involved or super complicated
- Easy to do on your phone

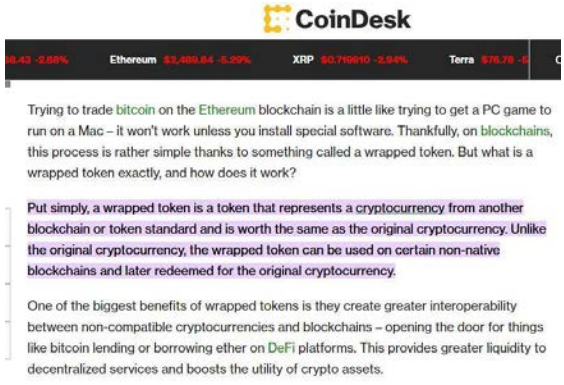
How to report staking income?

- No hard and fast guidance on these issues as of right now
- Best bet is to be transparent and consistent with regards to what is reported and where it is reported
- Schedule 1 Line 8 is common location for reporting staking income
- Used as the catch-all for various types of other earnings, winnings, or types of income
- No predetermined home for staking income at the IRS

Wrapped tokens

What??

What is a wrapped token?



CoinDesk

Ethereum XRP Terra

Trying to trade bitcoin on the Ethereum blockchain is a little like trying to get a PC game to run on a Mac – it won't work unless you install special software. Thankfully, on blockchains, this process is rather simple thanks to something called a wrapped token. But what is a wrapped token exactly, and how does it work?

Put simply, a wrapped token is a token that represents a cryptocurrency from another blockchain or token standard and is worth the same as the original cryptocurrency. Unlike the original cryptocurrency, the wrapped token can be used on certain non-native blockchains and later redeemed for the original cryptocurrency.

One of the biggest benefits of wrapped tokens is they create greater interoperability between non-compatible cryptocurrencies and blockchains – opening the door for things like bitcoin lending or borrowing ether on DeFi platforms. This provides greater liquidity to decentralized services and boosts the utility of crypto assets.

- https://www.coindesk.com/learn/what-are-wrapped-tokens/#:~:text=Put%20simply%2C%20a%20wrapped%20token,redeemed%20for%20the%20original%20cryptocurrency.
- But what does this actually mean?

Implications of wrapped tokens

- Bitcoin is the largest and most well-known blockchain protocol and platform, but is not the most robust or even widely developed
- Ethereum and ERC-20 tokens are popular for
  - Smart contracts
  - NFTs
  - Decentralized finance
- Wrapped tokens allow holders of bitcoin (for out example) to obtain functionality on this more widely developed blockchain
- Cool, but what about taxes???

Quick take on wrapping bitcoin

- Wrapped bitcoin (wBTC) is most popular wrapped token currently
  - Well over $10 billion
- Wrapping bitcoin involves the following steps
  - Own bitcoin (obviously)
  - Find a wBTC provider
  - Merchant sends BTC to a custodian who mints your wBTC and holds your BTC
  - Can be redeemed, and wBTC is destroyed when BTC is returned to you
- Maintains the constant level of BTC (21 million hard cap)
- Allows BTC holders to monetize crypto holdings

Taxes on wrapped tokens

- Wrapped tokens are treated the same as other virtual or digital currencies under current IRS guidance
- Ordinary income or capital gains treatment
- Same disclosure and reporting rules apply
- Earnings denominated in crypto usually reported at FMV at the date they are earned
  - Open to debate
- Question also includes whether wrapping the token represents a crypto-to-crypto swap (taxable), or just holding the same asset with a different name (non-taxable)

Bridged crypto?

How Do Blockchain Bridges Work?

Blockchain bridges can do a lot of cool stuff like converting smart contracts and sending data, but the most common utility is token transfer. For example, bitcoin and Ethereum are the two largest cryptocurrency networks and have vastly different rules and protocols. Through a blockchain bridge, bitcoin users can transfer their coins to Ethereum and do with them what they otherwise could not on the bitcoin blockchain. That can include purchasing various Ethereum tokens or making low-fee payments.

When you have bitcoin and want to transfer some of it to Ethereum, the blockchain bridge will hold your coin and create equivalents in ETH for you to use. None of the crypto involved actually moves anywhere. Rather, the amount of BTC you want to transfer gets locked in a smart contract while you gain access to an equal amount of ETH. When you want to convert back to BTC, the ETH you had or whatever's left of it will get burned and an equal amount of BTC goes back to your wallet.

If you would do this regularly, you'd have to convert bitcoin to ETH on a trading platform, withdraw it to a wallet then deposit again to another exchange. By the time it gets there, you'd have incurred more fees than probably what you planned to do in the first place.

- Think of it like how PayPal can be used to pay for almost every online transaction
- Another attempt to approve the interoperability around blockchain and cryptoassets
- Is this taxable?
- https://blog.liquid.com/blockchain-cross-chain-bridge#HowDoBlockchainBridgesWork

Non-fungible token focus

First things first

- In order to purchase an NFT the vast majority of these tokens can only be purchased with ETH
- So in order to even buy an NFT in the first place (more on that in a second)
- Investors/customers need to have access to crypto in the first place
- Potential doubling of taxable and reportable events

NFT, explained

- Digital assets that are connected and represent an underlying asset
- Every NFT contains distinctive and identifiable information that makes it distinct from any other NFT
- Cannot be exchanges directly for each other
- Cannot be sub-divided like bitcoin can be sub-divided in Satoshi's
- Reduces the potential for fakes/forgeries due to blockchain foundation

NFT License

- Put forward by Dapper Labs
- Contract template that can be customized to specify what rights are conveyed
- Distinguishes the NFT from the underlying art or asset
- Clarifies that the NFT holder obtains a 1) personal license to use and display the art, and 2) a commercial license to merchandise and monetize the asset
  - $100,000 gross revenue limit
- Just one example

NFT Tax Treatment

Might be a bit different from other crypto taxes, which create a taxable event every time there is a transaction involving these digital assets

Since NFTs are just digital representations of physical assets, like real estate, would the tax treatment simply mirror the tax treatment of the underlying asset?

No definitive guidance on accounting, but income streams are possible depending on the use case…

NFT tax options?

- Non-fungible tokens (NFTs) can be taxed in variety of ways
  - Ordinary income for minters/creators or taxpayers who create them
  - Can also generate capital gains if held for over 12-month period
  - Might also be taxed at collectible rate if certain conditions apply
- Generally reported on form 8949
- Key point to remember is that not all NFTs are art
  - Either by definition
  - IRS classification

What is art?

(2) COLLECTIBLE DEFINED

For purposes of this subsection, the term "collectible" means—

(A) any work of art,

(B) any rug or antique,

(C) any metal or gem,

(D) any stamp or coin,

(E) any alcoholic beverage, or

(F) any other tangible personal property specified by the Secretary for purposes of this subsection.

FAQ #1 - How are NFTs different from other cryptoassets?

- The primary difference between NFTs and other cryptoassets can be boiled down to two facts. Firstly, NFTs are unique and distinct assets, so this means that that they cannot be exchanged for one another like bitcoin and other cryptocurrencies can be. Secondly, and since these cryptoassets represent distinct claims linked to assets, NFTs cannot be subdivided and used fractionally as a currency equivalent.

FAQ #2 - What is the accounting treatment for NFTs?

- Since there is no crypto-specific authoritative accounting guidance in the marketplace, the general rule is that cryptoassets are treated as the equivalent to indefinite lived intangible assets. That said, and something we will be exploring in more detail, depending on the underlying asset in question - as well as the process by which these NFTs are issued - the accounting treatment will change.

FAQ #3 - Is there a tax implication for NFTs?

- Generally speaking NFTs are taxed as property, which all cryptocurrency are treated and taxed as. Where the differentiation comes into play is whether or not a taxpayer is an NFT creator, or is simply buying and selling NFTs. Creators are taxed at the point in time that the NFT is sold, with any income being recognized as ordinary income. Buyers and sellers of NFTs are going to be taxed similar to how other cryptocurrencies are taxed, with long term capital gains rates, or short term (ordinary income) rates coming into play.
-

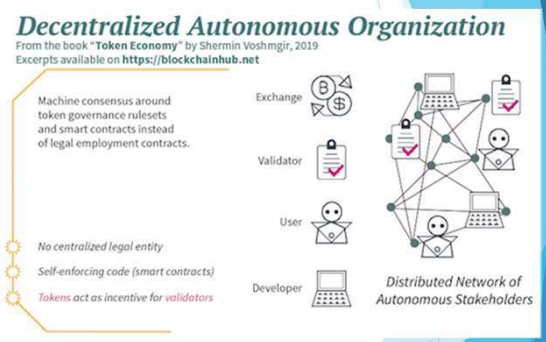
DAO Drilldown

What is a DAO

- A decentralized autonomous organization is a blockchain-based cooperative that is collectively owned by its members, with rules set and executed through code. DAOs replace centralized management structures with a techno-democratic approach wherein decisions are voted upon by investor-stakeholders. DAOs are built on top of blockchains (often Ethereum) and their transactions are visible on the underlying blockchain protocol.
- https://www.gemini.com/cryptopedia/the-dao-hack-makerdao#section-what-is-a-dao
- Decentralized, automated, and transparent
- Raises numerous tax issues based on how it is structured

Decisions are voted upon by investor-stakeholders

Driven by the issuance and holding of governance tokens



DAO Governance Highlights

DAOs can operate resembling more of a centralized organization or a traditional decentralized blockchain organization

Centralized - more like an incumbent organization/firm

Decentralized - tokens incentivize behavior

If decentralized, primarily governed by smart contracts

- Executable programmable code embedded into an underlying blockchain

Big picture issues?

- Can taxes be assessed on a DAO?
- If yes, how are those taxes paid and who pays them?
- Are payments from the DAO taxable?
- Is the receipt of governance tokens taxable?

Can taxes be assessed on a DAO

- The short answer is probably yes
- No definitive IRS DAO-specific guidance of this presentation
- Let's look at the criteria to determine whether an entity is taxable entity or not
- Entities are generally considered taxable when partners agree to work together and divide profits
- Sounds a lot like the smart contract driven governance of a DAO

- If a DAO earns profits from fees, investment strategies or other activities which individual or entity is liable?
- No clear cut guidance in the marketplace as of yet?
- Would every wallet-holder be liable for a proportional share of the income/earning of the DAO?
- OR, would the current IRS model for pass-through entities be followed?
- Taxes to be paid by the managing/members

Who pays these taxes?

Are payments from DAOs taxable?

- Yes
- Payments made from DAO controlled ETH-wallets are taxable income to those individuals/institutions that receive them
- If a user/investor funds a project, and receives a deposit from the associated DAO
  - Governed by a smart contract
- Those funds must be reported and will be subject to income taxes

Governance tokens

- What are governance tokens?
- Tokens distributed to users/managers/investors as part of a launch or as an incentive for activity on a certain protocol
- The receipt any token will generate a tax reporting and tax payment liability for the individual or institution

DAO Tax Summary

- No DAO-specific tax guidance as of yet
- DAOs could technically be classified, and have been, as taxable entities
- Assessing and collecting DAO taxes remains an open issue
- Receiving of tokens/payments from the DAO generates a tax reporting and payment item for individuals and institutions
- Contributing capital does not generate taxable events

First things first

- In order to purchase an NFT the vast majority of these tokens can only be purchased with ETH
- So in order to even buy an NFT in the first place (more on that in a second)
- Investors/customers need to have access to crypto in the first place
- Potential doubling of taxable and reportable events

Crypto Tax Planning

Qualified opportunity funds

Qualified opportunity fund

- Sec 1031 exchanges are not able to be made with cryptocurrency, BUT selling the cryptoassets and investing the gains with proceeds in a Sec. 1400Z-2(d) qualified opportunity fund (QOF) allows this divestment while allowing access to original cost basis
- Also can defer the recognition of capital gains
- Holds investments in QOF for 5 years, 10% exclusion from gross income
- 7 years, 15% exclusion from gross income
- 10 years, 100% exclusion of appreciation from gross income

Example of offering

- Not affiliated with this organization, so be sure to perform your own due diligence
- https://bitcapital.fund/opportunity-zones/
- Solid tax article explaining the benefits
- https://bitcapital.fund/opportunity-zones/
- Frequently asked questions about QOFs
- https://www.ictsd.org/is-a-qof-partnership-considered-a-security/

Corporate Transparency Act

What is the CTA?

- Corporate Transparency Act written as part of the Anti-Money Laundering Act (2020)
- Public comments had closed during February 2022
- No effective date as of yet
- What are the reporting requirements of this bill?
- https://www.natlawreview.com/article/what-emerging-growth-companies-and-investors-need-to-know-about-corporate

CTA reporting

- Requires that domestic and foreign "reporting companies"
  - Report certain identifying information concerning "beneficial owners"
  - Major equity owners
  - Managers
  - Directors
  - Senior officers
  - To FinCEN
- Failure to report can result in stiff penalties, including a $500 per day fine

CTA exclusions

- The CTA might seem like a blanket reporting requirement, but there are exempt entities
  - Certain publicly-traded entities
  - Banks
  - Large operating entities that filed a tax return showing revenue in excess of US $5 million per year, have over 20 FTEs, and physical operate in the U.S.
- Many crypto organizations would **not** be exempt from these reporting requirements
- What could this mean for the sector?

CTA intro wrap-up

- The CTA as currently written could create an onerous and crippling reporting requirement for crypto organizations
- Who is responsible for identifying the “beneficial owners?”
- What about DAOs?
- What about decentralized protocols, smart contracts, or other crypto-applications?

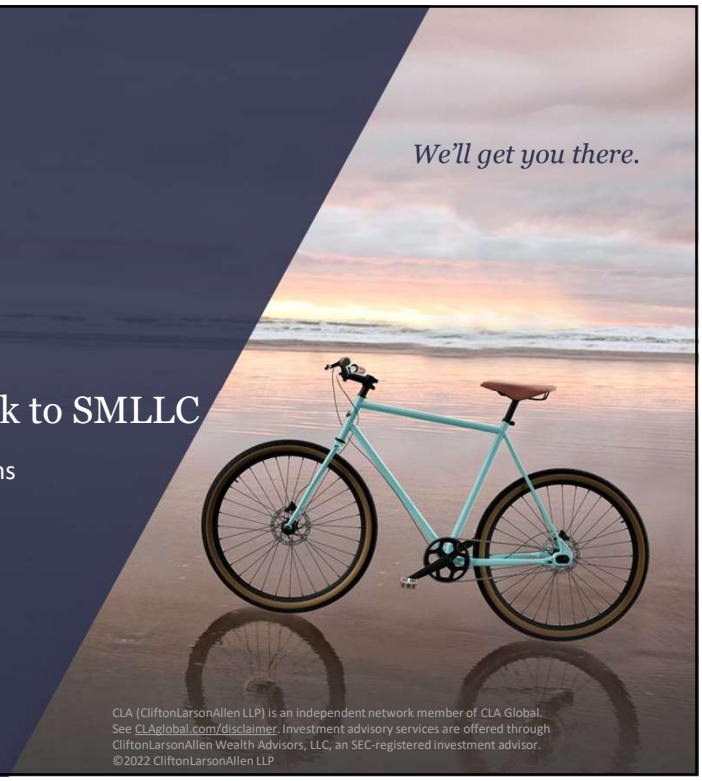
Thank you!

- Questions?
- Comments?
- Jokes?
- Twitter - @seansteinsmith
- LinkedIn – Sean Stein Smith

12:45 – 1:45 p.m.

SMLLC to Partnership & Back: Accounting for Rev. Rul. 99-5 & 99-6 Transactions

Ryan Sonnenberg, CPA, *Principal, CLA (CliftonLarsonAllen LLP)*



SMLLC to Partnership and back to SMLLC

Accounting for Rev. Rul. 99-5 & 99-6 Transactions

November 3rd, 2022

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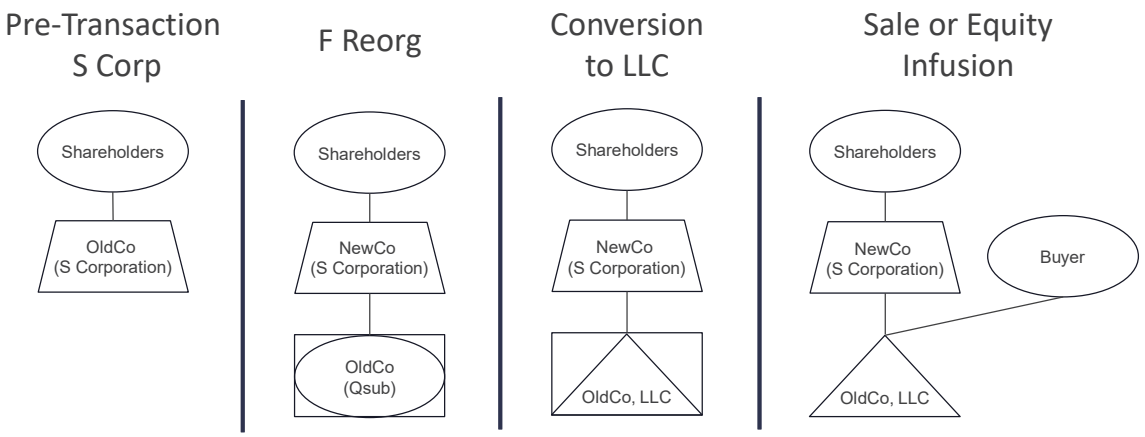
F Reorganization With 99-5 Steps



Disregarded Entity to Partnership: Rev. Rul. 99-5

Situation 1 – B purchase 50% of A's ownership in SMLLC

Situation 2 – B contributes cash to A's SMLLC in exchange for 50% ownership in SMLLC

99-5 – Situation 1

- B purchases 50% of A's ownership in SMLLC for $5,000
- A does not contribute any portion of the $5,000 to the LLC
- B is treated as if they purchased a 50% interest in each of the LLC's assets
- A is treated as selling assets and recognizes gain or loss
- A and B immediately contribute their respective 50% interests in the assets to the newly-formed partnership

99-5 – Situation 2

- B contributes $10,000 to A's SMLLC in exchange for 50% ownership in SMLLC
- The LLC uses all the contributed cash in its business
- A is treated as if they contributed the LLC's assets worth $10,000 to the newly-formed partnership
- Neither A nor B recognize gain or loss
- A's holding period of their partnership interest includes the holding period of the assets

99-5 – Considerations

- Bonus depreciation availability [Reg. § 1.168(k)-2(g)(1)(iii)]
- Anti-churning rules on amortizable intangibles [§197(f)(9)]
- §704(c) allocations
- §743(b) applicability
- "Pick and choose" applicability
- Holding period on subsequent sales

99-5 – §704(c) Allocations

SIMPLIFIED BALANCE SHEET

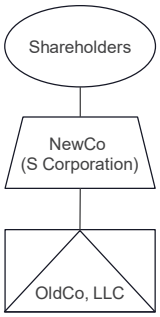
	TAX BASIS	VALUE
PRE-TRANSACTION		
Intangible	-	10,000
POST-TRANSACTION		
Intangible - A	-	5,000
Intangible - B	5,000	5,000
	5,000	10,000

TAX AMORTIZATION DEDUCTIONS

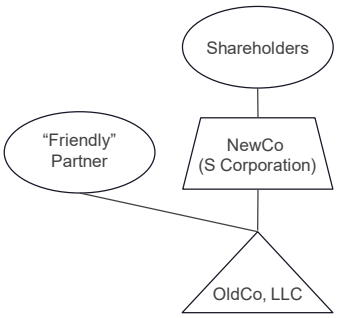
§704(c) TRADITIONAL METHOD	A	B
Intangible - A	-	-
Intangible - B	2,500	2,500
	2,500	2,500
§704(c) REMEDIAL METHOD		
Intangible - A	(2,500)	2,500
Intangible - B	2,500	2,500
	-	5,000

Avoiding 99-5 – Pre-form Partnership

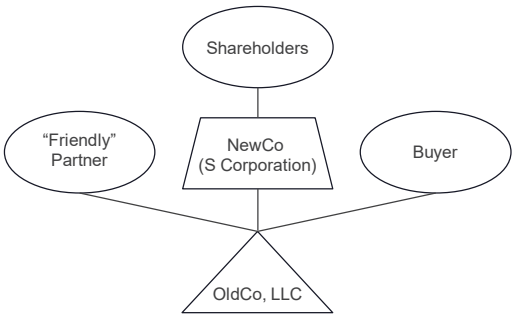
Post- F Reorg S Corp



Pre-Form Partnership

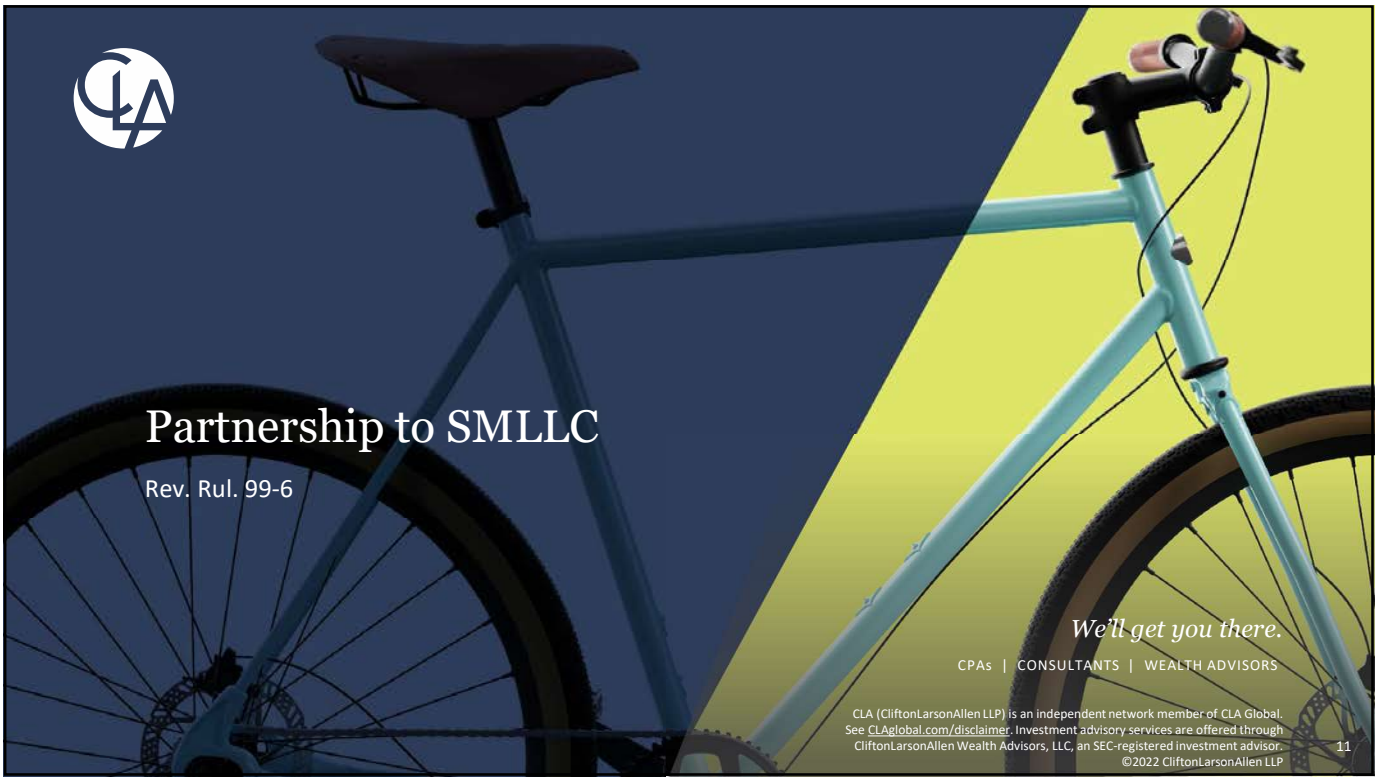


Sale to Buyer



Tax Return Reporting

L	**Partner's Capital Account Analysis**	
	Beginning capital account . . .	$
	Capital contributed during the year . .	$
	Current year net income (loss) . . .	$
	Other increase (decrease) (attach explanation)	$
	Withdrawals and distributions . . .	$ ( )
	Ending capital account	$
M	Did the partner contribute property with a built-in gain (loss)? ☐ **Yes** ☐ **No** If "Yes," attach statement. See instructions.	
N	**Partner's Share of Net Unrecognized Section 704(c) Gain or (Loss)**	
	Beginning	$
	Ending	$



Partnership to SMLLC

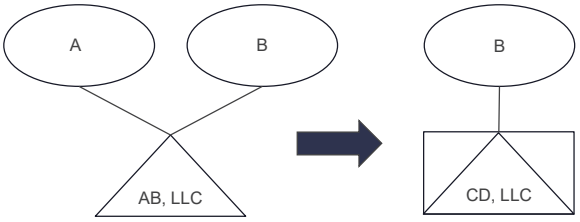
Rev. Rul. 99-6

We'll get you there.

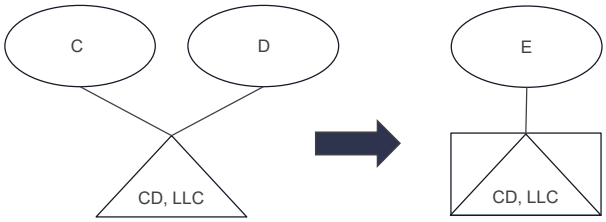
CPAs | CONSULTANTS | WEALTH ADVISORS

Revenue Ruling 99-6

Situation 1



Situation 2



Partnership to Disregarded Entity: Rev. Rul. 99-6

- Situation 1 – A & B are equal partners in AB partnership
  - B purchases all of A's ownership in AB
- Situation 2 – C & D are equal partners in CD partnership
  - C & D sell their entire interests to E

99-6 – Situation 1

- B purchases all of A's ownership in AB partnership for $10,000
- A is treated as selling a partnership interest [§741]
- B's treatment:
  - AB liquidates, distributing assets to both A & B
  - B acquires the assets A received in liquidation in a direct purchase from A
    - Carryover basis & holding period in the assets received on liquidation
    - $10,000 basis & new holding period in the "purchased" assets

99-6 – Situation 2

- C & D sell their entire interest to E for $10,000 each
- C & D are respected as selling partnership interests [§741]
- E's treatment:
  - CD liquidates, distributing assets to both C & D
  - E purchases all of the assets from C & D for $20,000
    - $20,000 basis & new holding period in the "purchased" assets

99-6 Tax Return Reporting

- Final partnership return
- §751(a) "hot asset" reporting – K-1 Line 20, Code AB
  - Form 8308
- No Form 8594 by partnership
  - Required by situation 2 purchaser

Ryan Sonnenberg, CPA
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CLAconnect.com

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2 – 3 p.m.

IRS Update

Michael Smith, *Senior Stakeholder Liaison, Internal Revenue Service*

2022 IRS Updates for Tax Professionals

IRS Stakeholder Liaison

Who we are:

- Team within IRS that establishes relationships with practitioner and industry organizations representing small business and self-employed taxpayers. We provide information about the policies, practices and procedures the IRS uses to ensure compliance with the tax laws.

What we do:

- Share IRS news and updates
- Education and outreach – (webinars, educational events, etc.)
- Issue Management Resolution System (IMRS) – tell us about IRS issues, we need your feedback!

Find us by searching "Stakeholder Liaison" on IRS.gov

Current IRS Messages

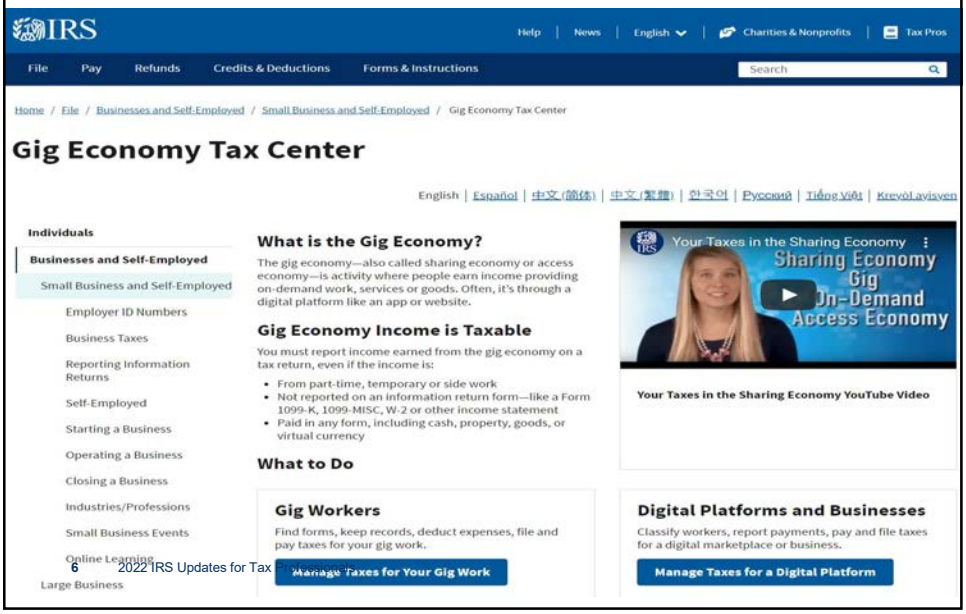
- The Gig Economy & Form 1099-K changes
- Online Account and Tax Pro Account
- Identity Protection PIN
- Tax Security Awareness
- Economic Impact Payments 1, 2 (2020) & 3 (2021)
- IRS Resources for Tax Professionals

The Gig Economy & 1099-K Changes

The Gig Economy

- What is the Gig Economy?
- Find resources at the Gig Economy Tax Center
  - Self-employed or employee?
  - Business recordkeeping
  - Rules for home rentals

Gig Economy Tax Center

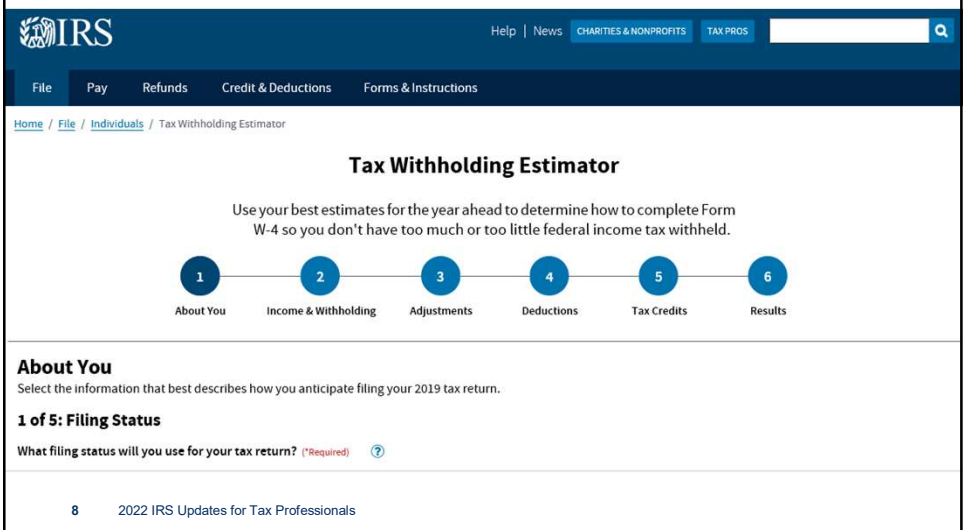


Key Points

- Gig income is taxable income
- Employee or Self-Employed
- Keep good records
- Visit the Gig Economy Tax Center for more info

Tax Withholding Estimator

IRS.gov/withholding



Tax Withholding Estimator

- Plain language used within the tool
- Ability to effectively target tax due or refund
- Determines self-employment tax
- Mobile-friendly design
- Taxpayers encouraged to check their withholding in January and July (at a minimum)

Form 1099-K, Payment Card and Third Party Network Transactions - Threshold Change

Understanding your Form 1099-K

Form 1099-K, Payment Card and Third Party Network Transactions, is an IRS information return used to report certain payment transactions.

- You should receive Form 1099-K from a payment settlement entity by January 31st if, in the prior calendar year, you received payment:
  - Through a payment card transaction, for example, through debit cards, credit cards, prepaid cards, gift cards, etc., and/or
  - In settlement of third party network transaction above the minimum reporting threshold for the provision of goods or services.

If you received payments from the same payor that include both payment card and third party network transactions, you should receive a separate Form 1099-K reporting the gross amount from each type.

Form 1099-K Minimum Reporting Threshold for Third Party Payment Network Transactions

For returns for calendar years prior to 2022:

- Aggregate amount of payments for goods and services exceeds $20,000, **AND**
- More than 200 such transactions

For returns for calendar years 2022 forward:

- Aggregate amount of payments for goods and services exceeds $600
- This is determined without regard to the number of transactions

Does not include receipt of payments from family or friends for gifts, shared trips, reimbursements, etc.

Income Reporting and Recordkeeping

- You must report all taxable income you receive on your income tax return.
- Your business's books and records should reflect your business income including amounts that may be reported on Form 1099-K.

In most cases, your business income will be in the form of:

- Cash
- Checks and Electronic Funds Transfers (EFTs)
- Debit/credit card payments*
- Payments received through third party network transactions*

*Generally reported on Form 1099-K

Form 1099-K is used to report the gross amount of total reportable transactions for the calendar year without regard to any adjustments for credits, cash equivalents, discount amounts, fees, refunded amounts, or any other amounts.

IRS.gov resources

Understanding Your 1099-K

Understand Form 1099-K, Payment Card and Third Party Network Transactions, and what you should do if you receive one.

About Form 1099-K, Payment Card and Third Party Network Transactions

Includes recent updates, related forms, and instructions on how to file.

General FAQs on Payment Card and Third Party Network Transactions

General frequently asked questions on Payment Card and Third Party Network Transactions.

Publication 334 Tax Guide for Small Business (For Individuals Who Use Schedule C or C-EZ)

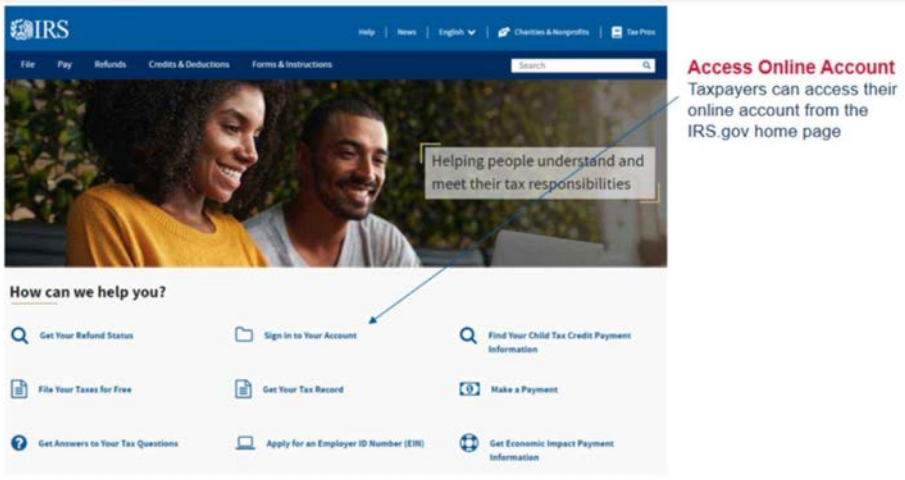
Contains general information about the federal tax laws that apply to small business owners.

Communications & Liaison
STAKEHOLDER LIAISON

Online Account

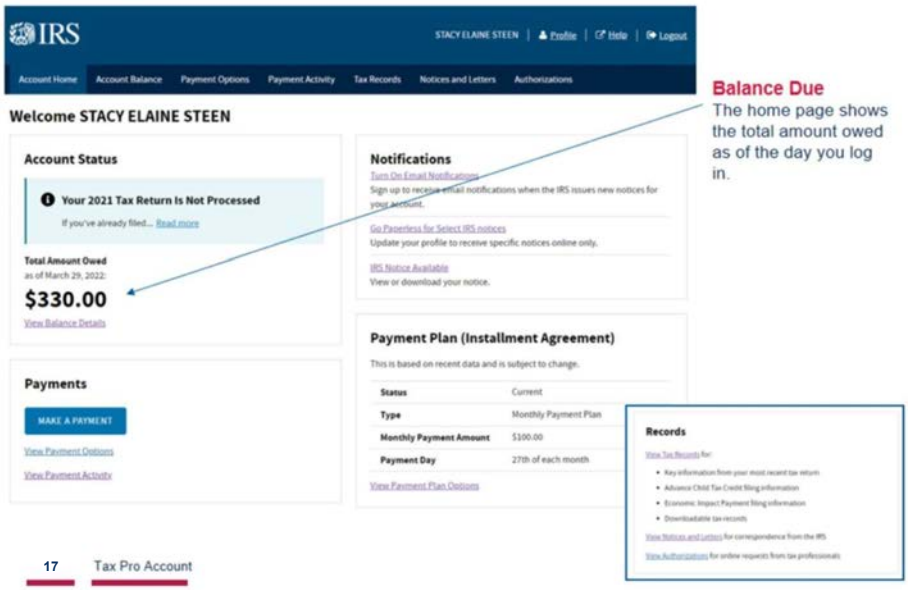
A self-service tool for individual taxpayers to securely access their account information.

IRS.gov home page takes you to Online Account



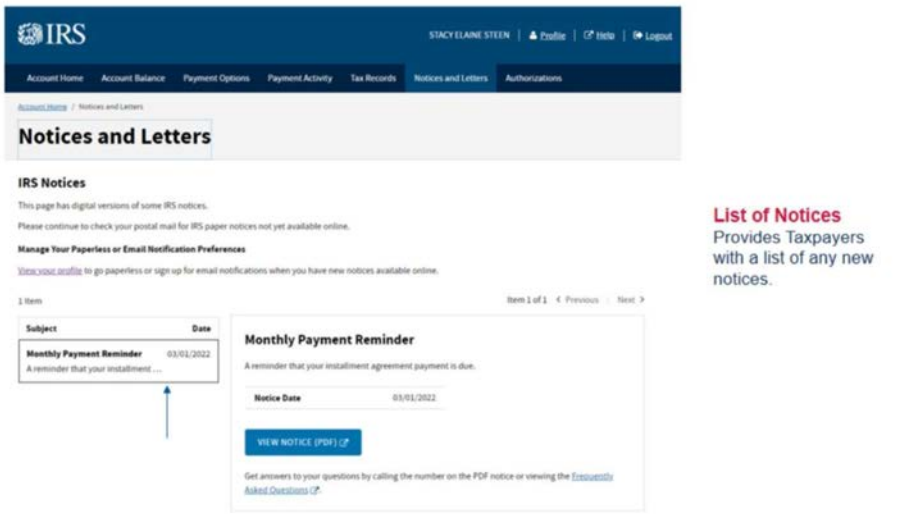
Access Online Account
Taxpayers can access their online account from the IRS.gov home page

Account Home shows key data about the taxpayer's account



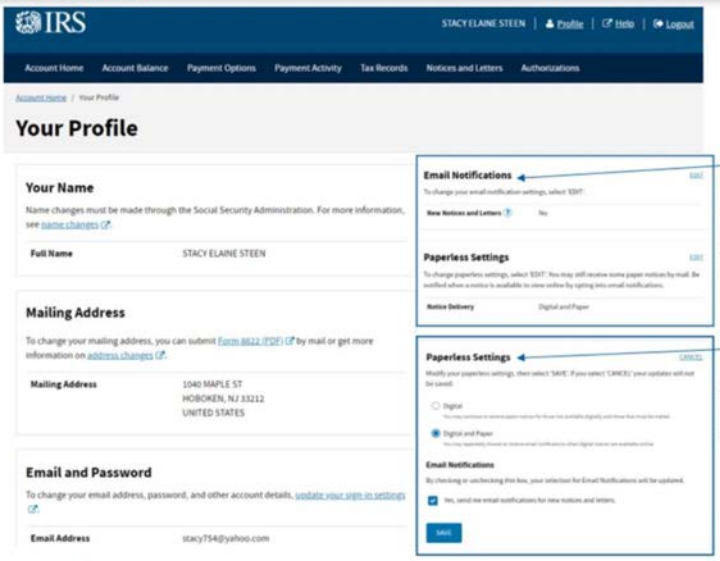
17 Tax Pro Account

Notices and Letters provides digital copies of select IRS correspondence



18 Tax Pro Account

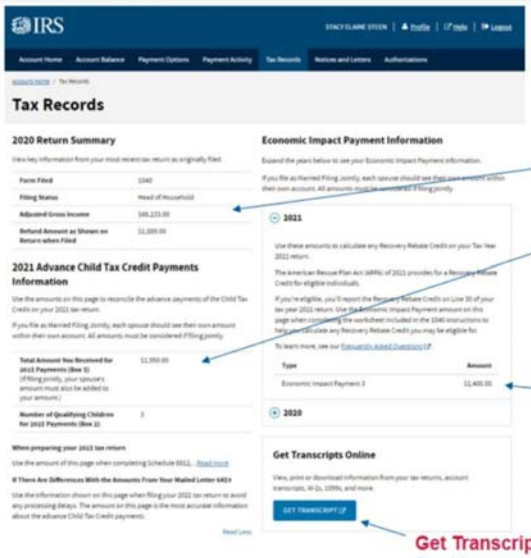
Profile displays key taxpayer contact information – cont.



Email Notifications
Taxpayers can sign up to receive email notifications for important account information

Paperless Setting
Taxpayers can choose to go paperless for notices available online

Tax Records provides important data for tax returns



Key Data from Most Recent Tax Return
Clearly highlights key information for taxpayers from their most recent return.

Advanced Child Tax Credit Payment Info
Tax Records can find the information needed to file their 2021 tax returns.

Economic Impact Payment Info
Tax Records now show Economic Impact Payment amounts for qualifying taxpayers.

Get Transcripts
Provides access to account and return transcripts online

Office of Online Services

Tax Pro Account

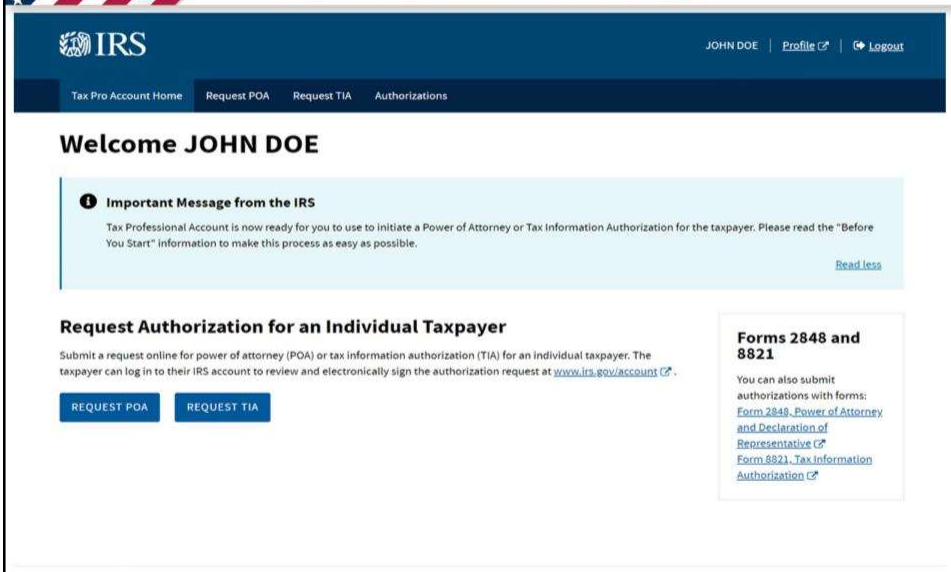
Expanding Services for Taxpayers

Expansion of Taxpayer Options for 3rd Party Authorizations launched in the summer of 2021

- Added "authorization" feature to individual Online Accounts.
- Launched Tax Pro Account on IRS.gov to allow tax professionals to initiate online POA or TIA requests.
  - Tax professional initiates a POA or TIA, uses checkbox as electronic signature for POAs.
  - POA or TIA requests automatically transfers to individual taxpayer's Online Account.
  - Taxpayer accesses their Online Account and under the "Authorization" tab they can approve the request and use a checkbox as signature.
  - Upon approval, authorization is posted immediately to CAF.

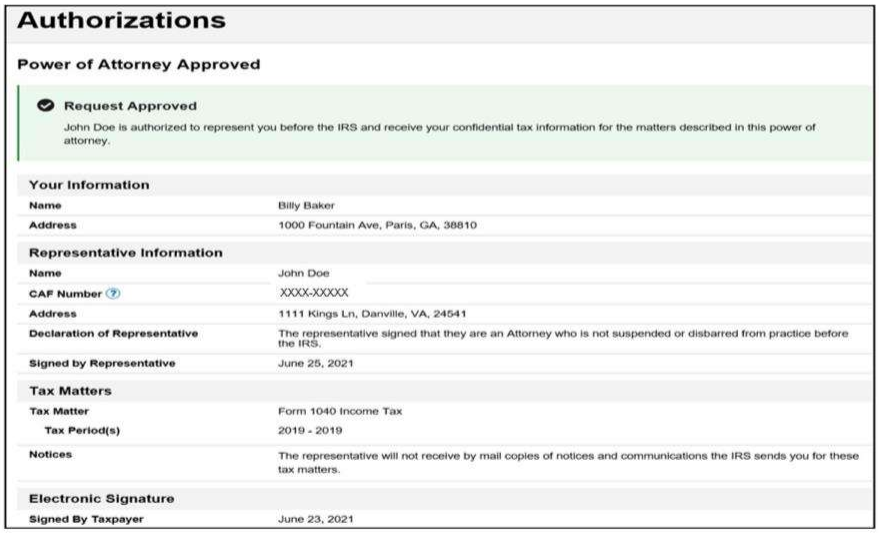
Individual Tax Pro Account Home Page

Notional



Taxpayer Approval of POA Request

Notional



Tax Pro Account: Future State

- IRS will continue to expand Tax Pro Account capabilities to improve its features for authorization requests and to add functionality as resources allow.
- Here are just some of the features we are working, planning, or considering:
  - Notification to the taxpayer regarding action in their Online Account, to include pending authorization requests
  - Email alerts letting the tax professional know when taxpayer approves their authorization request
  - Taxpayer's ability to view their complete authorization history.
  - Tax professional's ability to view and manage all their active authorizations on CAF processed through all channels

The Identity Protection PIN (IP PIN)

Proactively protect your federal tax account from identity theft.

What is the IP PIN?

- An Identity Protection PIN (IP PIN), is a six-digit number that prevents someone else from filing a tax return using your Social Security number or Individual Taxpayer Identification Number
- The IP PIN helps the IRS to verify your identity when you file your electronic or paper tax return
- Even though you may not have a filing requirement, an **IP PIN still protects your account from fraudulent filings**
- An electronically filed return filed without your IP PIN, or an incorrect IP PIN, will reject, including your return and any fraudulent returns using your Social Security Number.
- Any paper returns filed without your correct IP PIN will undergo additional scrutiny and any fraudulent returns will be removed from your account. If the return verifies to be yours, we will continue to process it.

Who can obtain an IP PIN?

- Anyone who has a Social Security number (SSN) or Individual Taxpayer Identification Number (ITIN) and can verify his/her identity is eligible to enroll into the IP PIN program (Voluntary Enrollment)
- Victims of federal tax related identity theft are automatically enrolled into the IP PIN program (Automatic Enrollment)

How can a taxpayer voluntarily enroll into the IP PIN Program?

Get An Identity Protection PIN (IP PIN) Online Application

- Fastest and most secure method to enroll
- Protection begins right after enrollment
- IP PIN is immediately available for filing

Find the IP PIN Program

Go to IRS.gov, keyword "IP PIN"

Other methods to enroll in the IP PIN Program?

Form 15227, Application for an IP PIN

- For taxpayers who cannot verify their identity through the Online Application
- Process can take up to 180 days to complete enrollment
- Taxpayer must include a telephone number for call back verification
- Limited to taxpayers under a certain adjusted gross income level

In-Person at a local Taxpayer Assistance Office

- For taxpayers who cannot verify their identity through the Online Application or the Form 15227 process or are ineligible to file a Form 15227
- Appointments may be limited due to availability

Get An Identity Protection PIN (IP PIN)

Other details

- IP PIN is displayed online after verification, and it can be retrieved at anytime by logging back into the application
- The IP PIN online application is generally available starting in mid-January through mid-November
- Taxpayers who have an existing IRS Online Account may be able to use their log in information to access the Get An IP PIN Application

How does a Taxpayer receive their IP PIN?

- Each December, new IP PINs are generated for the upcoming filing season for current enrollees
- CP 01A notices containing the new IP PIN are mailed from mid-December to mid-January
- Taxpayers who enrolled voluntarily online must log back into the Get an IP PIN application to retrieve their current IP PIN (These taxpayers will not receive a CP 01A notice)
- The Get an IP PIN application is available from late January to mid-November

How does a Taxpayer receive their IP PIN?

- The following taxpayers will receive a CP 01A notice each year:
  - Form 15227 applicants
  - In-person TAC applicants
  - Identity theft victims who did not enroll online (If a valid address cannot be confirmed then the CP 01A notice is suppressed)*
  - Taxpayers who enrolled online prior to January 2019

*If this happens, these taxpayers may not know they have an IP PIN until they attempt to electronically file a return and it's rejected.

What if a Taxpayer Lost or Doesn't Receive an IP PIN Notice?

Taxpayers may receive their current year IP PIN by:

- **Accessing the Get An IP PIN Application** (Fastest Method)
  - Retrieve their IP PIN by logging into their account on IRS.gov
  - If the taxpayer does not have an account, they can create an account and retrieve their IP PIN
- **Calling the IRS help line at 800-908-4490**
  - Taxpayer will need to verify their identity and current mailing address
  - After verification is completed, a 4869C notice containing their IP PIN will be mailed to the taxpayer within 21 days

Note: If the taxpayer cannot obtain their IP PIN through either option, then the best alternative is to file a paper return without their IP PIN.

Tax Security Awareness

Phishing Email Example

Dear Tax Pro,

Your electronic filling identification number (EFIN) has temporary been put on hold due to suspicious activity with your PTIN user.

Did you transmit the below 1040 form?

TranscriptPDF

If this was you, please ignore this message.
If it was not you, please immediately change your password.
Failure to confirm this request will leads to EFIN suspended.

We are trying to protect your e-service and EFIN account.

Sincerely.

Carol A Campbell
IRS.gov e-service

Business Email Example

-----Original Message-----

From: Mickey Mouse <mk@mu.se>

Sent: Tuesday, January 22, 2019 1:03 PM

To: Minnie Mouse <minnie@realbusiness.org>

Subject: Request

Hi Minnie,

I need you to email me 2018 W2s of all employees.
How soon can you get me those?

Regards

Mickey Mouse

Source: www.nist.gov/cyberframework

Example: E-mail Warning Labels

From: [redacted] [mailto [redacted]]
Sent: Tuesday, June 12, 2018 2:01 AM
To: [redacted] <[redacted]>
Subject: Final Reminder for Notice of Tax Overpayment

**** This is an EXTERNAL email. Exercise caution. DO NOT open attachments or click links from unknown senders or unexpected email. ****

1

Source: www.nist.gov/cyberframework

Signs of Client Data Theft

- **Client e-filed returns begin to reject**
- **Clients who haven't filed tax returns begin to receive authentication letters (5071C, 4883C, 5747C) from the IRS**
- **Clients who haven't filed tax returns receive refunds**

Data breach – Info for affected clients or employees

- IRS Pub 5027, Identity Theft Information for Taxpayers
- Place a “fraud alert” or “credit freeze” with at least one of the three credit bureaus
- File a complaint with the Federal Trade Commission
- Review FTC’s www.identitytheft.gov for additional steps

Data Compromise Action Items

Contact IRS and law enforcement

- **Tax professionals contact IRS Stakeholder Liaisons immediately**
  - Search “stakeholder liaisons” on IRS.gov

Data Compromise Actions - continued

Contact State Agencies:

- State revenue agencies – email Federation of Tax Administrators for state agency contacts at StateAlert@taxadmin.org
- State Attorneys General

Contact experts:

- Security expert
- **Insurance company**

Data Compromise Actions - continued

Contact Clients and Other Services

- FTC for guidance for businesses
  - Email: **idt-brt@ftc.gov**
- Credit Bureaus
- Clients

Review guidance at IRS.gov/identitytheft

Reporting phishing emails

Email: phishing@irs.gov

- Forward phishing emails with federal tax related contact to this address.
- Forward phishing text messages to: 202-552-1226

File a complaint with the FBI's IC3

- Search "IC3" or Internet Crime Complaint Center

Develop a Written Information Security Plan

IR-2022-147, August 9, 2022

WASHINGTON — The Security Summit partners today unveiled a special new sample security plan designed to help tax professionals, especially those with smaller practices, protect their data and information.

The special plan, called a Written Information Security Plan or WISP (PDF), is outlined in a 29-page document that's been worked on by members of the Security Summit, including tax professionals, software and industry partners, representatives from state tax groups and the IRS.

Economic Impact Payments

and

The Recovery Rebate Credit

2020
1st Economic Impact Payment

First Economic Impact Payments were in the following amounts:

- Each eligible individual received up to $1,200
- Married couples filing a joint return received up to $2,400.
- People with qualifying children under age 17 at the end of the taxable year (2018 or 2019) received up to an additional $500 for each qualifying child.

2020
2nd Economic Impact Payment

Second Economic Payments are in the following amounts:

- Each eligible individual received up to $600
- Married couples filing a joint return received up to $1,200.
- People with qualifying children under age 17 at the end of 2019 received up to an additional $600 for each qualifying child.

2021
3rd Economic Impact Payment

Third Economic Impact Payment

- The third Economic Impact Payments were in the following amounts:
- Each eligible individual received up to $1,400
- Married couples filing a joint return received up to $2,800
- People with qualifying children received $1,400 for each qualifying dependent

2020 and 2021 Tax Returns

Taxpayers who didn't receive their EIPs can file a tax return to claim **Recovery Rebate Credits**.

In general, taxpayers only have a three-year window from the original due date, normally the April deadline, to claim their refunds.

In general:

- For 2020 Form 1040 - **April 15th, 2024**
- For 2021 Form 1040 - **April 15th, 2025**

IRS Resources

for

Tax Professionals

e-News for Tax Professionals

Information about:

- Recent changes affecting tax pros
- IRS news releases and announcements
- Links to tax pro pages on IRS.gov
- Other information of interest to tax pros

IRS.gov – Search for keyword: e-News

IRS social media

Instagram – @IRSnews

Twitter:

@IRSnews

@IRSenEspanol

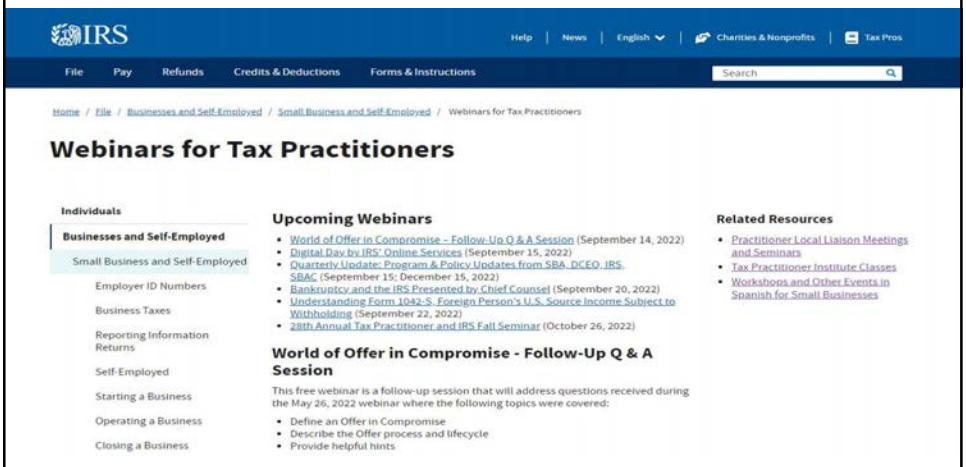
@IRStaxsecurity

YouTube: IRS Videos in English, Spanish and American Sign Language

Facebook: IRS, IRS en Español, IRS Tax Pros

IRS Webinars

IRS.gov – Search for keyword: **webinars**



Stakeholder Liaison

IRS.gov – Search for keyword**: stakeholder liaison**

Contact information

Michael Smith

IRS Stakeholder Liaison - Wisconsin

211 W Wisconsin Ave, Milwaukee, WI 53203

(414) 231-2199

michael.smith6@irs.gov

- **Report issues with IRS policies, practices, procedures**
- **Help navigating IRS processes**
- **Presentations/workshops on current IRS issues or tax topics**

3:10 – 4 p.m.

Corporate Transparency Act

James Howard, *Partner, Foley & Lardner LLP*

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FOLEY & LARDNER LLP

The Corporate Transparency Act

Wisconsin Institute of CPAs
November 3, 2022

James Howard

Program Outline

- Background and overview
- Reporting companies and exclusions
- Beneficial owner
- Company applicant
- Reporting requirements
- Reporting changes to information
- Other issues
- Burdens
- Q&A

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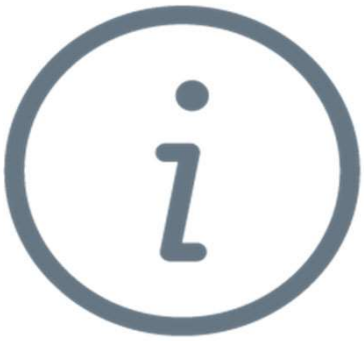
Background and Overview



FinCEN

- **Financial Crimes Enforcement Network (FinCEN)**
  - Under the U.S Department of the Treasury
- **FinCEN mission**
  - Safeguard the financial system from illicit use
  - Combat money laundering and its related crimes, including terrorism
  - Promote national security through strategic use of financial authorities and the collection, analysis, and dissemination of financial intelligence

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Corporate Transparency Act (CTA) Overview

- **Part of the 2021 National Defense Authorization Act**
  - Enacted on Jan. 1, 2021
  - Proposed in 2019
- **Places disclosure obligations on reporting companies**
  - Reporting companies must submit a report to FinCEN with certain personal information of each beneficial owner and applicant.
- **Reporting company**
  - Any domestic corporation, LLC, or similar entity.
  - Any foreign company that registers to do business in the U.S.
  - Numerous exceptions apply for companies already regulated at the federal or state level and for large companies with a U.S. operating location.

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Corporate Transparency Act (CTA) Overview (Continued)

- **Beneficial owner**
  - Any individual who has 25% ownership or exercises substantial control
- **Applicant**
  - The person that files a document to form or register a company

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CTA Penalties

- **Civil**
  - $500/day for each day violation continues – up to $10,000
- **Criminal**
  - Imprisonment for up to two years

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FinCEN Rule-Making

- **Advance Notice of Proposed Rule-Making (ANPRM)**
  - Released April 1, 2021.
  - Comment period ended May 5, 2021.
- **Notice of Proposed Rule-Making**
  - Released December 7, 2021
  - Comment period ended February 7, 2022
- **Final Rule**
  - Published September 30, 2022

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FinCEN Rule-Making—Policies and Next Steps

- **Regulations target small companies**
  - Aimed primarily at smaller, lightly regulated companies that may not be subject to other beneficial owner reporting requirements.
- **Regulations were written broadly**
  - Intended to bring as many companies as possible within the reporting requirements.
  - Drafted to promote law enforcement interests and not to minimize the burdens imposed on reporting companies, beneficial owners, and applicants.

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FinCEN Rule-Making—Policies and Next Steps (Continued)

- **Exceptions were narrowly limited**
  - Exceptions apply to the narrowest subset permitted by law.
- **Current regulations just the first round of rule-making**
  - FinCEN expects two more rounds of rule-making to address specific areas of the CTA.

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Effective Date

- **January 1, 2024**

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BOSS

- FinCEN has been developing the Beneficial Ownership Secure System to receive, store and maintain beneficial ownership information ("BOI")
- FinCEN expects BOI reports to be submitted through electronically through an online interface
- BOSS will be secured to a Federal Information Security Management Act "High" compliance level, the highest information security protection level under the Act.

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Reporting Companies and Exclusions

Reporting Company

- **"Reporting company" means a corporation, LLC, or similar entity**
  - Domestic reporting company - created by filing a document with the secretary of state or similar office of a state or American Indian tribe; or
  - Foreign reporting company - Formed under the law of a foreign country and registered to do business in the U.S. by filing a document with the secretary of state or similar office of a state or American Indian tribe.
  - "similar entity" was left to FinCEN rule, but FinCEN chose not to expand on the definition.

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Reporting Company Exclusions

- **CTA provides list of excluded entities**
  - The CTA provides 23 specific exclusions from the definition of reporting company.
  - Generally applies to regulated businesses.
- **Examples of regulated entities that are not reporting companies**
  - Financial institutions.
  - Companies subject to Security and Exchange Commission (SEC) regulation.
  - Public utilities.
  - **Accounting Firms** – any firm registered in accordance with section 102 of Sarbanes-Oxley (15 USC 7212).

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Reporting Company Exclusions (Continued)

- **Large operating companies**
  - An entity with more than 20 employees, filed a U.S. income tax return for the previous year showing at least $5 million of **gross receipts or sales**, and has an operating presence at a physical office in the U.S.
- **Other exclusions**
  - FinCEN was given authority to do so but did not exclude any types of entities in regulations other than those enumerated by the CTA.

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Large Operating Company Exclusion

- **20 or more full-time employees**
  - The CTA did not clarify what constitutes an employee.
  - FinCEN looked to IRS definition of full-time employee.
  - IRS provides that a full-time employee is one who averages 30 hours per week or 130 hours per month.
- **$5 million in US gross receipts**
  - FinCEN's final rule clarifies that gross receipts means gross receipts from U.S. income.
  - At least $5 million in gross receipts or sales must be reported on the entity's applicable IRS form, excluding amounts from sources outside the United States.

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Large Operating Company Exclusion (Continued)

- **Operating presence at a physical office within the U.S.**
  - Must be a physical office owned or leased by the company.
  - Cannot be a residence or shared space (except for affiliates).

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Beneficial Owner

Beneficial Owner—CTA § 5336(a)(3)

- **Beneficial owner means an individual who**
  1. Exercises substantial control over the entity; or
  2. Owns or controls not less than 25% ownership of the entity.
- **Substantial control**
  - CTA did not define what constitutes substantial control over the entity.
- **25% ownership**
  - CTA did not define what constitutes ownership or how to calculate 25%.

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Beneficial Owner—Substantial Control

- **Substantial control includes**
  - Service as a senior officer of the reporting company.
  - Authority over the appointment or removal of any senior officer or majority ~~or dominant minority~~ of the board of directors.
  - Direction, determination, or ~~decision or~~ substantial influence over important matters affecting the reporting company.
  - Any other form of substantial control over the reporting company.

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Beneficial Owner—Substantial Control (Continued)

- **Substantial control generally**
  - Provision is broadly drafted.
  - Substantial control may be exercised directly or indirectly.
  - More than one person may exercise substantial control.
  - Not intended to include ordinary daily managerial decisions.

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Substantial Control Factors—Important Company Matters

- Sale, lease, or transfer of principal assets of the reporting company.
- Reorganization, dissolution, or merger of the reporting company.
- Financial decisions, such as expenditures, investments, debt or budget.
- Selection or termination of business lines.
- Compensation and incentive schemes.
- Entry into, termination of, or fulfillment of significant contracts.
- Amendments of company governance documents, and significant policies and procedures.

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Beneficial Owner—25% Ownership

- **Ownership interest**
  - Any equity or anything classified as stock interest.
  - A capital or profit interest in an LLC or partnership.
  - ~~Any proprietorship interest.~~
  - Any instrument convertible to equity or stock interest.
  - An option or privilege to buy or sell any of the foregoing interests without an obligation to do so.
    - Similar to IRC attribution rules, options deemed exercised for purposes of determining beneficial ownership.
  - Any other instrument, contract, arrangement, understanding, relationship or mechanism to do so.
- **Calculation of 25% ownership**
  - Aggregate of all the individual's ownership interests of any class or type that the individual owns or controls and compare the aggregated interest to the undiluted ownership interests of the company.
  - For a corporation, 25% of either vote or value will trigger.
  - If not clear, 25% of ANY class or type or ownership interest is deemed to be 25%+

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Exclusions from Beneficial Owner

- **Rule mirrors exceptions in the CTA text**
  - Minor child, if parent or guardian is reported under the CTA.
    - **Note: child reaching maturity is a change requiring an updated report.**
  - An individual acting as a nominee, intermediary, custodian, or agent on behalf of another individual.
  - An individual acting solely as an employee, whose economic benefit or control is derived solely from the person's employment status – cannot be a senior officer.
  - An individual whose only interest in the entity is through a right of inheritance.
  - A creditor, unless the creditor meets the beneficial owner definition.

Exclusions from Beneficial Owner (Continued)

- **Rule provides some clarifications**
  - Clarifications ensure that companies must identify real parties of interest.
  - Clarifies that senior officers of a company do not fall within the employee exception.
  - Clarifies that right to inheritance is a future interest.

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Company Applicant

Company Applicant

- **CTA requires reporting of applicant information**
  - Generally same requirements as for a beneficial owner.
- **"Applicant" means an individual who either:**
  - Files an application to form a corporation, LLC, or other similar entity under the laws of a state or American Indian tribe; or
  - Registers or files an application to register a corporation, LLC, or similar entity formed under foreign law to do business in the U.S. by filing a document with the secretary of state or similar office of a state or American Indian tribe.
  - The individual responsible for directing or controlling the filing if more than 1 individual is involved.
    - Lawyer-paralegal = 2 applicants
    - Employee of filing service agent generally not an applicant
    - Employee of the governmental authority accepting the filing is not an applicant

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Company Applicant (Continued)

- **Multiple company applicants**
  - The Rule clarifies that the reporting company may need to report information for multiple company applicants.
- **Existing Reporting Companies**
  - Entities existing as of 1/1/2024 need not report company applicant.
    - FinCEN recognized the challenge in tracking down applicants from years ago who may be deceased, whereabouts unknown, etc.

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Reporting Requirements

Initial Report Deadlines

- **New domestic reporting companies**
  - Applies to entities formed on or after January 1, 2024.
  - Required to file initial report **within ~~14~~30 calendar days** of filing formation documents.
- **New foreign reporting companies**
  - Applies to foreign entities that register on or after January 1, 2024.
  - Required to file initial report **within ~~14~~30 calendar days** of filing registration documents.
- **Existing reporting companies**
  - Applies to both domestic and foreign reporting companies already in existence on January 1, 2024.
  - Initial report must be filed **not later than January 1, 2025**.

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Company Information for Reporting Companies

- **Information to report for each reporting company**
  - Full legal name of the reporting company.
  - All trade names, fictitious names, or DBAs.
  - Business street address of the reporting company.
  - Jurisdiction of formation (state or tribal).
  - IRS taxpayer identification number (TIN).

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Company Information for Reporting Companies (Continued)

- ~~**If reporting company lacks a TIN at time of reporting**~~
  - ~~Company must report its Dun & Bradstreet Data Universal Numbering System (DUNS), or~~
  - ~~Legal Entity Identifier (LEI).~~
- **Business street address**
  - The address of a registered agent or other third party is not sufficient.

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Beneficial Owner—Required Information

- **A reporting company must provide for each beneficial owner**
  - Full legal name of the individual.
  - Date of birth for the individual.
  - Residential street address.
  - A unique identifying number from certain government documents issued to the individual.
  - An image of the document that provided the unique identifying number.

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Beneficial Owner—Required Information (Continued)

- **Acceptable sources of unique identifying number**
  - Nonexpired passport issued by the U.S.
  - Nonexpired identification document issued by a state, local government, or Indian tribe.
  - Nonexpired drivers license issued to the individual by a state.
  - Nonexpired passport issued by a foreign government.

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Company Applicant—Required Information

- **A reporting company must provide for each company applicant**
  - Full legal name of the individual.
  - Date of birth for the individual.
  - Address—see below.
  - A unique identifying number from certain government documents issued to the individual.
  - An image of the document that provided the unique identifying number that includes a photograph of the individual.

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Company Applicant—Required Information (Continued)

- **Address for company applicant**
  - If company applicant filed the formation or registration document in the course of the individual's business, the street address of such business is required.
  - In all other cases, the reporting company must provide the residential street address ~~that the individual uses for tax residency purposes~~.

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Reporting Changes to Information

Updates to Information Previously Provided to FinCEN

- **The CTA requires updates if reported information changes**
  - Reporting companies must update information submitted in prior reports to FinCEN not later than ~~one year~~ 30 days after the date on which there is a change with respect to any of that information.
- **Changes requiring an updated report**
  - Who is a beneficial owner; or
  - Information reported for any particular beneficial owner; or
  - Information reported for any particular applicant; or
  - Reporting company meets requirements for an exemption.

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Update Reports—Special Issues

- **Time of reportable change with respect to deceased beneficial owner**
  - Change is deemed to occur when the estate of a deceased beneficial owner is settled.
  - Updated report may still be required following date of death if the death of a beneficial owner causes another person to assume substantial control.
- **Multiple changes**
  - All changes must be reported, even if superseded by another change within the reporting window.
- **Changed or updated information reporting deadline**
  - Report must be submitted **not later than 30 calendar days after** the information changes.

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Corrections to Information on Initial Report to FinCEN

- **The CTA requires a correction of incorrect information in reports**
  - Reporting companies that inadvertently submit incorrect information in a report to FinCEN must file a corrected report to avoid civil and criminal penalties.
- **Contents of corrected report**
  - All information necessary to make the report complete and accurate.
- **Corrected report deadline**
  - Corrected report must be filed **within ~~14~~ 30 calendar days** after reporting company becomes aware or should have known of an error in the initial report.
    - 41Caution, safe harbor from civil and criminal penalties only applies if the corrected report is filed within 90 days after the inaccurate report was filed.

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Other Issues

FinCEN Identifier

- **Issued by FinCEN to simplify reporting**
  - Beneficial owner, company applicant, or reporting company may simply report its FinCEN identifier in lieu of all the information required by the CTA and regulations.
- **To obtain a FinCEN identifier**
  - An individual must submit an application containing all information required for a beneficial owner or company applicant.
  - An entity may obtain a FinCEN identifier when it submits a report as a reporting company or any time thereafter.
- **Limitations**
  - A FinCEN identifier is specific to the individual or entity to which it is issued.
  - An individual or reporting company may only obtain one FinCEN identifier.

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FinCEN Identifier Issues

- **Use of FinCEN identifier**
  - An individual cannot allow others to use the person's FinCEN identifier.
  - Could subject the holder to civil or criminal penalties.
- **Holder of FinCEN identifier must keep information updated**
  - Beneficial owner, company applicant, or reporting company shall file updated reports if any of the information contained in the application submitted to FinCEN changes.
  - May not be possible for a reporting company to identify changes to company applicant information.

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Reporting Violations

- **Clarifies what persons may be subject to penalties**
  - A person who controls or directs another to provide false or incorrect information or to fail to report.
- **Both individuals and reporting companies are subject to penalties**
  - FinCEN extended civil and criminal penalties to any person violating their obligations under the CTA or regulations.

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Burdens

FinCEN Burden Estimates

- FinCEN estimate of existing entities in 2024 that may be subject to reporting requirements = 36,581,506
- FinCEN estimate of new companies annually thereafter = 5,616,362
- FinCEN estimates of time burden:
  - 20 minutes to read and understand the form
  - 30 minutes to identify and collect information about beneficial owners and applicants
  - 20 minutes to fill out and file the report, including attaching acceptable identification document
  - 70 minutes in total
- FinCEN estimated hourly wage rate of professional preparing form = $56.76

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FinCEN Burden Estimates (Continued)

Table 2 – Burden and cost of initial BOI reports per reporting company:

Description	Simple Structure (59%)	Intermediate Structure (36.1%)	Complex Structure (4.9%)
Read FinCE BOI documents, understand requirement, and analyze reporting company definition	40 minutes	170 minutes	300 minutes
Identify, collect and review information about beneficial owners and company applicants	30 minutes	135 minutes	240 minutes
Fill out and file report	20 minutes	65 minutes	110 minutes
Total time burden to file:	90 minutes	370 minutes	650 minutes
Avg. wage rate to file (in dollars)	$56.76	$56.76	$56.76
Professional expertise cost (in dollars)	$0	$1,000	$2,000
Cost per initial report:	**$85.14**	**$1,350.00**	**$2,614.87**

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FinCEN Burden Estimates (Continued)

Table 5 – Total Burden and Costs

Year 1			
Activity	**Count of reports**	**Burden Hours**	**Cost**
Initial BOI Reports	32,556,929	118,572,335	$21,673,487,885.48
Updated BOI reports	6,578,732	7,657,096	$1,038,524,428.72
FinCEN identifier applications for individuals	325,569	108,523	$6,159,488.81
FinCEN identifier updates for individuals	12,180	2,030	$115,218,68
FinCEN costs			$82,000,000.00
Totals	39,473,410	126,339,984	**$22,800,287,021.69**

Years 2+			
Activity	**Count of reports**	**Burden Hours**	**Cost**
Initial BOI Reports	4,998,468	18,204,421	$3,327,532,419.21
Updated BOI reports	14,456,425	16,826,105	$2,282,108,290.77
FinCEN identifier applications for individuals	49,985	16,662	$945,666.84
FinCEN identifier updates for individuals	26,575	4,429	$251,386.22
FinCEN costs			$35,600,000.00
Totals	19,531,480	35,051,617	**$5,646,437,763.04**

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Q&A

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3:10 – 4 p.m.

Section 1202: Understanding the Often Overlooked Gain Exclusion

James DeCleene, J.D., *Senior Associate, Michael Best & Friedrich LLP*

Chris McNamara, J.D., Associate, *Michael Best & Friedrich LLP*

Hamang Patel, J.D., Partner, *Michael Best & Friedrich LLP*

1202 – Qualified Small Business Stock

Hamang B. Patel
James W. DeCleene
Christopher G. McNamara

Thursday November 3, 2022

Overview

1. **Introduction**
2. **Benefits of QSBS**
   - 100% Exclusion of Gain
   - 1202 "Flip" Technique
   - Multiplication of Exclusion
   - Sec. 1045 Deferral
3. **Technical Issues**
   - Issuance Requirements
   - Corporate Requirements
   - Miscellaneous
4. **State Tax Considerations**
5. **Current Proposals to Change QSBS Treatment**

Benefits of QSBS – 100% Exclusion of Gain

- **Up to 100% of the gain from the sale or exchange of QSBS held for more than 5 years may be excluded from gross income.**

Benefits of QSBS – 100% Exclusion of Gain (cont'd)

The percentage of gain excluded depends on when the QSBS was acquired:

Stock Acquisition Date	Exclusion Percentage	Maximum Section 1202 Gain Rate	Maximum QSBS AMT Rate	Maximum LTCG Rate (No QSBS)
Aug. 11, 1993 to Feb. 17, 2009	50%	15.9%	16.88%	23.8%
Feb. 18, 2009 to Sept. 27, 2010	75%	7.95%	9.42%	23.8%
After Sept. 27, 2010	**100%**	**0%**	**0%**	23.8%

- *Lee, Comeau, Kwon, & Long, Qualified Small Business Stock: Quest for Quantum Exclusions*, Tax Notes Federal (Jul. 6, 2020), at 22.

Benefits of QSBS – 100% Exclusion of Gain (cont'd)

- **Gain exclusion is limited to the *greater of*:**
  - **$10,000,000** (reduced by any prior gain taken into account under 1202 w/r/t the issuing corporation) OR
  - **10x the aggregate adjusted bases of QSBS** issued by the corporation and disposed of by the taxpayer *during the taxable year*.
- Special Rules
  - $10M reduced to $5M for married filing separate taxpayers.
  - If filing a joint return, each spouse is treated as having been allocated ½ of the gain for purposes of applying 1202 in future years.
  - For purposes of the 10x limit, no additions to basis after the date on which the stock was originally issued count.
  - **Practice Pointer: If additional capital contributions are to be made to the corporation, consider whether new stock should be issued in exchange for the contribution.**

Benefits of QSBS – 100% Exclusion of Gain (cont'd)

- **Limitations are applied on a per-taxpayer and per-corporation basis.**
  - Ex: Corp. A has 100 shareholders all of whom are individuals who are unrelated to each other. Each shareholder would be entitled to a separate $10M or 10x exclusion.
  - Ex: During CY 2022, Taxpayer sells QSBS from Corp. A acquired in 2012 for $1 at a $5M gain and sells QSBS from Corp. B acquired in 2014 for $1 at a $7M gain. Assuming that the taxpayer has never excluded gain with respect to the sale of QSBS from either Corp. A or Corp. B, then all $12M of gain would be excluded because neither the $5M of gain from the sale of Corp. A stock nor the $7M from the sale of Corp B. stock exceeds $10M separately.
  - Ex: If the Taxpayer in the prior example had previously excluded $6M of gain under 1202 on the sale of a separate lot of Corp. A stock, then gain exclusion for CY 2022 would be limited to $4M.

Benefits of QSBS – 1202 "Flip" Technique

- **10x limit on gain exclusion is determined by reference to the "aggregate adjusted bases" of QSBS disposed of by the taxpayer during the year.**
- However, a special rule provides that, solely for purposes of 1202, the basis of QSBS shall not be less than the *fair market value* of the property exchanged for the stock.
- Idea is to wait for the LLC to build value before incorporating so that the fair market value of the property deemed contributed to the new corporation is as high as possible.
  - Ex: An LLC classified as a tax partnership with 2 50/50 members has $100,000 of assets and no liabilities on Day 1. If the LLC incorporates on Day 1, then the basis of the stock in the hands of the two members for 1202 purposes is $100,000 ($50,000 each). The 10x limit would be $500,000 for each member.
  - Ex: Same as the prior example, but the LLC incorporates on Day 2 when the LLC has $12,000,000 of assets and no liabilities. The 10x limit would be applied to the $12M amount since that was the fair market value of the property exchanged for the stock at the time of incorporation, which means the 10x limit for each member would be $60M.
  - The Fair Market Value can be > $50M. The thing to watch is the amount of cash (and 1202 basis of other assets) invested.

Benefits of QSBS – 1202 "Flip" Technique (cont'd)

- **Drawbacks to the "Flip"**
  - The 5-year holding period requirement does not begin to run until the LLC incorporates, so if a sale event is on the horizon, it may make sense to flip sooner rather than later. (Judge this relative to the ability to do an asset sale in an LLC and get buyers a step up in basis on those assets – a fact that can be used to negotiate a higher purchase price.)
  - ***The special rule that the FMV of the assets contributed to the corporation counts as the QSBS's basis applies in determining gain eligible for exclusion, not just calculating the 10x benefit.***
- ***Examples***
  - Ex: A owns 100% of LLC, a DRE for tax purposes, into which he has invested $100,000. On Day 1, the LLC is worth $100,000, but A decides to wait to incorporate. On Day 2, the LLC is worth $8,000,000, and A decides to incorporate. The maximum amount of gain that can be excluded in a single year under the 10x limitation is $80,000,000. However, A ends up selling LLC on Day 3 for $10,000,000. A's basis in his QSBS is viewed, solely for purposes of 1202, as being $8,000,000, which means only $2,000,000 of gain is eligible for exclusion under 1202 despite A having $9,900,000 of gain for other tax purposes. Had A incorporated on Day 1, A would have had a basis in his QSBS of $100,000 for purposes of 1202 and the $10M limitation would have soaked up 100% of the gain on the sale. In this situation, A loses out on $7,900,000 of gain exclusion, which is taxed at normal LTCG and NIIT rates (23.8%) - a potential $1.9M tax hit.
  - Ex: Same as above, but on Day 3, A sells the business for $80,000,000. In this situation, A's basis for 1202 purposes is $8,000,000, which means there is $72,000,000 of gain excluded under 1202, which is $62M more gain excluded than if A had incorporated on Day 1. The remaining $7,900,000 of gain is taxed at normal LTCG and NIIT rates (23.8%).

Benefits of QSBS – 1202 "Flip" Technique (cont'd)

- **Practice Pointer: The 1202 "Flip," if done correctly, can maximize the gain excluded under 1202, but it may not be prudent for companies with more modest sales expectations. Also, care should be taken to ascertain how far out a sale is so the 5-year holding period requirement isn't tripped.**

Benefits of QSBS – Multiplication of Exclusion

- **With appropriate, advanced planning, it may be possible to multiply the exclusion to a substantial extent**.

Benefits of QSBS – Multiplication of Exclusion (cont'd)

- Structure ownership from the outset, either by the Founders initially or with respect to preferred stock purchased by an investor, to include a spouse, adult children, and other family members.
  - May not be tolerated by VC funds.
  - May not be desired by Founders when value is low and control issues trump future tax planning.
- Gifts to spouse
  - Technically, each spouse on a joint return is a "taxpayer."
  - If each spouse has title to separate shares of QSBS, then each spouse is likely to be able to claim a separate $10M / 10x exclusion. This is the case even though the statute explicitly halves the $10M exclusion for MFS returns.
    - Query: What if the shares were not originally titled in the spouse's name? Would a subsequent transfer be a "gift" for income tax purposes?
    - Query: Would the anticipatory assignment of income doctrine apply if a sale was imminent?
  - **Practice Pointer: Gifts of QSBS to a spouse should occur as soon as possible and not close to an anticipated sale.**

Benefits of QSBS – Multiplication of Exclusion (cont'd)

- Gifts to others individually, at death, or through trusts.
  - Trusts generally should be non-grantor trusts.
  - Multiple trust rules (643(f)) and substance over form doctrine may aggregate multiple, identical trust agreements for the same beneficiary.
  - Will trigger obligation to file Form 709 (Gift Tax Return) if completed gift for gift tax purposes.
  - Gifts to a QTIP trust benefiting a spouse may eliminate some of the concerns of direct gifts to a spouse.
- What is not a gift?
  - Transfers to revocable trusts.
  - Transfers to irrevocable, grantor trusts, including IDGTs, grantor CLATS, etc.
  - Any other transfer where the original owner is still treated as the owner of the property for income tax purposes.
  - LIKELY DOES NOT matter if the transfer is a completed gift for gift tax purposes.

Benefits of QSBS – Multiplication of Exclusion (cont'd)

- Operate different lines of businesses in separate corporations.
  - Might complicate a later sale.
  - Might not make operational sense if business lines are highly integrated.
  - Treasury has been directed to "prescribe such regulations as may be appropriate . . . to prevent the avoidance of the purposes of this section through split-ups, shell corporations, partnerships, or otherwise." IRC s. 1202(k). No regulations addressing this issue have been promulgated to date.

Benefits of QSBS – Sec. 1045 Deferral

- **A taxpayer who has held QSBS for > 6 months and purchases replacement QSBS within 60 days after a sale of that QSBS can elect to roll over the capital gain on the stock sold into the replacement stock.**
  - Gain will be recognized to the extent that the gain was not reinvested.
  - The basis in the purchased shares will be reduced to preserve the gain inherent in the sale transaction.
  - Ex: A purchases QSBS in Corp. A for $1,000,000 on January 1, Year 1. On January 1, Year 2, A sells the stock in Corp. A for $1,500,000, and on February 1, Year 2, A acquires QSBS in Corp. B for $1,300,000. A makes a 1045 election for the sale of the Corp. A stock. A realizes $500,000 of gain on the sale and recognizes $200,000 of that gain. The remaining $300,000 of realized gain reduces A's basis in the Corp. B stock such that A's basis is $1,000,000.
- Special rules apply where the QSBS is held and sold by a partnership.

Benefits of QSBS – Sec. 1045 Deferral (cont'd)

- Making the election
  - Election is made on the taxpayer's tax return for the year in which the QSBS was sold (not the year the replacement QSBS was purchased).
  - Election is made by reporting the gain on the sale of the QSBS as if it would all be recognized and entering the unrecognized amount as an adjustment to that gain. [2021 Instructions to Schedule D, Form 1040, at D-9]
  - Special rules apply where a partnership sold the QSBS.
- **Practice Pointer: Clients selling QSBS prior to the 5-year mark (but after 6 months) may be able to defer the gain on the sale by purchasing replacement QSBS within a 60-day window. Given the short timeframe, it is beneficial to target potential investments ahead of a sale so that the new investment can be closed timely.**

Technical Issues – Issuance Requirements

- **Issuance requirements**
  - Stock must have been originally issued after August 10, 1993.
  - The corporation issuing the stock must be a "qualified small business" at the time of issuance.
  - With some exceptions, QSBS must be acquired by the taxpayer at its original issue.
  - QSBS must be received in exchange for money or other property (but not stock) or as compensation for services provided to such corporation.

Technical Issues – Issuance Requirements (cont'd)

- **The corporation issuing the stock must be a "*qualified small business*" at the time of issuance.**
  - Must be a domestic corporation which is a C corporation.
  - The corporation (and its predecessors) cannot have had > $50,000,000 in aggregate gross assets at any time from August 10, 1993 through immediately after issuance (taking into account amounts received in the issuance).
    - For this purpose, you add the amounts of cash and the *aggregate adjusted bases of other property* held by the corporation.
    - But, any contributed property is treated as having an adjusted basis equal to its fair market value as of the time of such contribution. Presumably, any contributed property which is depreciable would have to track a separate amount of depreciation for 1202 purposes to determine the adjusted basis of such property over time.
    - So, you do *not* just look at the value from a third-party appraisal, especially if the corporation has significant amounts of non-cash contributed property, other property for which it took depreciation, and/or property that has appreciated significantly (e.g., goodwill).
    - Parent-subsidiary controlled groups (> 50% vote or value) are aggregated in making this determination.
  - Query: Would a small corporation spun off from a much larger C corporation be permanently ineligible? If a corporation purchases all of the assets from another corporation, is the selling corporation considered a predecessor?

Technical Issues – Issuance Requirements (cont'd)

- **With some exceptions, QSBS must be acquired by the taxpayer at its original issue.**
- Exceptions include:
  - Transfers by gift or at death.
  - Transfers from a partnership to a partner, but not vice versa.
  - Transfer from an S corporation to a shareholder *is not* an exception.
  - Beware holding QSBS inside entities where ownership changes can inadvertently spoil original issuance.

Technical Issues – Issuance Requirements (cont'd)

- **QSBS must be received in exchange for money or other property (but not stock) or as compensation for services provided to such corporation.**
- Exceptions to the "in exchange for . . . stock" prohibition include:
  - Stock received solely via conversion of QSBS in the same corporation is itself QSBS.
    - A common stock for common stock exchange under 1036 seemingly doesn't count for this purpose.
    - Such an exchange may, depending on the circumstances, qualify as a Type E reorganization (a recapitalization).
  - Stock received as a stock dividend on QSBS or as part of a Type E or F reorganization is QSBS.
  - Incorporation and Reorganization Transactions.
    - If QSBS is exchanged for non-QSBS in a 351 or 368, the non-QSBS is treated as QSBS and is viewed as having been acquired on the date the QSBS was acquired. BUT, only the gain that would have been eligible for exclusion at the time of the exchange is eligible for exclusion on a later sale. 1202(h)(4)(D) requires the corporation issuing the stock in the 351 to be in 368(c) control of the old 1202 corporation immediately after the transaction.
    - If QSBS is exchanged for QSBS in a 351 or 368, then the excludible gain is not capped.
    - Ex: A owns Corp. X stock which is QSBS. A purchased the stock for $1,000,000 on Day 1. On Day 2, Corp. X is the Target entity in a reverse triangular merger meeting the requirements of IRC s. 368(a)(2)(E), and A receives Corp. Y stock worth $5,000,000 which does not separately qualify as QSBS. On Day 3, A sells the Corp. Y stock for $8,000,000. Despite the Corp. Y stock being treated as QSBS, just the $4,000,000 of gain inherent in the Corp. X stock on Day 2 is eligible for exclusion under 1202. The remainder of the gain is subject to taxation at 23.8%.

Technical Issues – Corporate Requirements

- **Corporate Requirements**
  - C corporation status
  - Active business requirement
  - No disqualifying redemption transactions

Technical Issues – Corporate Requirements (cont'd)

- **C corporation status**
  - At the time of the sale or exchange of QSBS, the corporation must be a C corporation. *See* IRC ss. 1202(a)(1) (excluding gain from the sale or exchange of "qualified small business stock"); 1202(c)(1) (defining QSBS as "any stock in a C corporation").
  - Further, the issuing corporation must be a C corporation "during substantially all of the taxpayer's holding period of such stock." IRC s. 1202(c)(2)(A).
  - Last, as noted above, the issuing corporation must also be a C corporation at the time of issuance.
  - **Practice Pointer: Given that a corporation must be a C corporation at sale, during substantially all of the taxpayer's holding period, and at the issuance of the stock, it is generally advisable to ensure that S status is not elected for the corporation during any part of the taxpayer's holding period. Otherwise, you would have to argue that the presence of 1 or 2 intervening S years does not violate the "substantially all" requirement for which there is no current definition.**

Technical Issues – Corporate Requirements (cont'd)

- **A corporation must meet the active business requirements during "substantially all of the taxpayer's holding period for such stock."**
  - No guidance on what "substantially all" means for this purpose or how it is determined.
  - Usually, "substantially all" is within the 80-90% range in other contexts.
- The active business requirements are met for a period if during that period:
  - (i) the corporation is an eligible corporation AND
    - Must be a domestic corporation.
    - CANNOT be a DISC or former DISC, a RIC, a REIT, a REMIC, or a cooperative.
  - (ii) at least 80% of the corporation's assets (by value) are used in the "active conduct of 1 or more qualified trades or businesses."

Technical Issues – Corporate Requirements (cont'd)

- **Active business requirement: >= 80% of the corporation's assets (by value) are used in the "active conduct of 1 or more qualified trades or businesses."**
  - **Qualified Trade or Business – Any trade or business other than**
    - Service trades or business in professional fields (e.g., health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services).
    - Any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees.
    - Banking, insurance, financing, leasing, investing, or similar businesses.
    - Farming businesses (including raising or harvesting trees)
    - Oil/gas wells and mineral extraction.
    - The operation of a hotel, motel, restaurant, or similar business.
    - Note: Novel startups can push the limits on these categories so be careful and forewarn your client.

Technical Issues – Corporate Requirements (cont'd)

- **Active business requirement: >= 80% of the corporation's assets (by value) are used in the "active conduct of 1 or more qualified trades or businesses."**
  - Automatic DQs – A corp does **not** meet the active business requirement for a period if
    - (i) > 10% of the total value of its assets consists of real property which is not used in the active conduct of a trade or business (dealing in, or renting of, rental property is not viewed as active for this purpose) OR
    - (ii) > 10% of the value of its **net** assets consists of portfolio stock or securities of non-subsidiary corporations which is not held to meet working capital needs.

Technical Issues – Corporate Requirements (cont'd)

- **Active business requirement: >= 80% of the corporation's assets (by value) are used in the "active conduct of 1 or more qualified trades or businesses."**
  - Working Capital Rules
    - Assets held as part of the reasonably required working capital needs of a QTB are counted.
    - Assets held for investment to finance R&D within 2 years are counted.
    - If corporation is > 2 years old, cannot count more than 50% of assets as reasonably required working capital.
  - Other Special Rules
    - Corporation is deemed to own ratable portion of subsidiary's (> 50% vote or value) assets and to conduct ratable portion of subsidiary's activities.
    - Assets used to conduct start-up activities or certain R&D activities are deemed to be used in the active conduct of a qualified trade or business for this purpose even if the corporation does not have gross income from such activities at the time of determination.
    - Rights to computer software which produces active business computer software royalties (IRC s. 543(d)(1)) treated as an asset used in the active conduct of a trade or business.

Technical Issues – Corporate Requirements (cont'd)

- **Practice Pointer**: Advise clients to keep records, e.g., financial statements, values of assets, etc., that could be used to show the active business requirement was met during any relevant periods.

Technical Issues – Corporate Requirements (cont'd)

- **No disqualifying redemption transactions**
  - Redemptions within 2 years on either side of issuance
    - In general: Stock is not QSBS if, in one or more purchases during the 4-year period beginning on the date 2 years before the issuance of the stock, the issuing corporation purchases (directly or indirectly) more than a de minimis amount of its stock *from the taxpayer or from a person related* (within the meaning of section 267(b) or 707(b)) *to the taxpayer*.
    - De minimis amount: Stock acquired from the taxpayer or a related person is de minimis unless (i) the aggregate amount paid for the stock exceeds $10,000 and (ii) more than 2 percent *of the stock held by the taxpayer and related persons* is acquired. The percentage of stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock held (directly or indirectly) by the taxpayer and related persons immediately before the purchase. The percentage of stock acquired in multiple purchases is the sum of the percentages determined for each separate purchase.
  - Examples:
    - Partnership AB purchases 150 shares of Corp. X stock on January 1, 2021. On February 28, 2021, Corp. X redeems all 150 shares of its stock owned by Partnership AB, a partnership in which A owns 75% of the capital interests and B owns 25% of the capital interests. At the time of the redemption, Partnership AB's 150 shares were worth $15,000. On December 31, 2022, A purchases 100,000 shares of Corp. X stock for $10,000,000. No other shareholders in Corp. X are related to either Partnership AB or A. In this situation, all 150 shares of Partnership AB's stock would be DQ'd and not treated as QSBS (and thus ineligible for any 1045 deferral) because the aggregate amount paid for the stock exceeds $10,000 and the percentage of stock purchased was 100% ($15,000 / $15,000). Similarly, all of A's shares purchased on December 31, 2022 would similarly be DQ'd because the redemption of Partnership AB's stock was within 2 years prior to the issuance of stock to A, was for more than $10,000, and represented 100% of the value owned by A or persons related to A at the time of the redemption.
    - Same as the prior example, but A's purchase took place on January 1, 2021 for $10,000,000. In this situation, neither Partnership AB's stock nor A's stock is DQ'd because, at the time of the redemption of Partnership AB's stock, such stock represented <2% of the value owned by Partnership AB and A ($15,000 / $10,015,000 = 1.50%).

Technical Issues – Corporate Requirements (cont'd)

- **No disqualifying redemption transactions**
  - Redemptions within 1 year on either side of issuance.
    - In general: Stock is not QSBS if, in one or more purchases during the 2-year period beginning on the date 1 year before the issuance of the stock, the issuing corporation purchases more than a de minimis amount of its stock and the purchased stock has an aggregate value (as of the time of the respective purchases) exceeding *5 percent of the aggregate value of all of the issuing corporation's stock as of the beginning of such 2-year period*.
    - De minimis amount: Stock acquired is de minimis unless (i) the aggregate amount paid for the stock exceeds $10,000 and (ii) more than 2 percent *of all outstanding stock* is purchased. The percentage of the stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock outstanding immediately before the purchase. The percentage of stock acquired in multiple purchases is the sum of the percentages determined for each separate purchase.
  - Example:
    - On December 31, 2020, Corp. X has a value of $1,000,000. On July 1, 2021, Corp. X has a value of $2,000,000, and Individual A has $20,000 of Corp. X stock redeemed. On December 31, 2021, Corp. X issues $10,000 of stock to each of C, D, E, F, and G as compensation for services. On November 1, 2022, Corp. X has a value of $3,050,000, and Individual B has $35,000 of Corp. X stock redeemed. In this situation, all of the stock issued to C, D, E, F, and G are DQ'd and not treated as QSBS because the aggregate amount paid for all redemptions in the 2-year period exceeded $10,000 (total of $55,000), such redemptions totaled 2.15% ($20,000/$2,000,000 + $35,000/$3,050,000) as of the time of the respective purchases, and the aggregate amount paid for all redemptions exceeded 5% of the aggregate value of all of the corporation's stock as of December 31, 2020 ($55,000 / $1,000,000), the date 1 year prior to the issuance of the stock.
    - Query: What happens if a corporation is incorporated on January 1, 2022, issues stock on July 1, 2022, and a redemption takes place for 3% of the stock worth $100,000 on November 1, 2022? The 2-year period begins on July 1, 2021. Since the corporation wasn't formed at that time, should the value be $0 for purposes of applying the "5 percent of the aggregate value" test?

Technical Issues – Corporate Requirements (cont'd)

- **Practice Pointer: Be wary of any purchases by a corporation of its own stock if 1202 status is intended to be preserved, especially within the first year of incorporation.**

Technical Issues – Corporate Requirements (cont'd)

- **No disqualifying redemption transactions**
  - **Certain purchases are disregarded:**
    - If a shareholder transfers stock to a service provider of the Company, the transfer is not treated as a purchase by the Company even if Treas. Reg. s. 1.83-6(d) would recharacterize the transfer as a transfer of the stock to the Company followed by a transfer from the Company to the service provider. NOTE, however, that the stock received would not be at original issuance.
    - Termination of Services
      - Employee / Director – A purchase of stock by a Company is disregarded if (i) the stock was received by an employee or director in connection with the performance of services and (ii) the stock is purchased in connection with the "retirement" or "other bona fide termination" of such services.
      - Independent Contractor – NO SIMILAR EXCEPTION.
    - Death
      - A purchase of stock by a Company is disregarded if prior to decedent's death, stock was held by decedent or spouse, decedent and a joint tenant, or a revocable trust established by the decedent or decedent's spouse AND
      - (i) The stock is purchased from the decedent's estate, beneficiary (whether by bequest or lifetime gift), heir, surviving joint tenant, or surviving spouse, or from a trust established by the decedent or decedent's spouse AND
      - (ii) The stock is purchased within 3 years and 9 months from the date of the decedent's death.
    - Disability / Incompetency – Disregarded if purchase was incident to the disability or mental incompetency of the selling shareholder.
    - Divorce - Disregarded if purchase was incident to the divorce (within the meaning of section 1041(c)) of the selling shareholder.

Technical Issues – Corporate Requirements (cont'd)

- **Practice Pointer: Be wary of any repurchase of the stock of an independent contractor since such purchases are <u>not</u> disregarded when applying the disqualifying redemption rules.**

Technical Issues – Miscellaneous

- **Miscellaneous**
  - Only non-corporate taxpayers, e.g., individuals, trusts, and estates, can exclude gain under 1202.
  - Stock must have been held for > 5 years.
    - Tacked holding periods generally do not apply except in the case of QSBS acquired as a gift, at death, from a partnership to a partner, through the conversion of other QSBS, or in certain 351 or 368 transactions.
    - If stock is received from the conversion of convertible debt or from the exercise of stock options or warrants, the holding period for this purpose does not begin until the date of the conversion or exercise.
    - The holding period for stock received as compensation for services begins when income for the award is taken into account under section 83 of the Code. So, if stock is subject to vesting, generally, the holding period for 1202 purposes does not start until the stock vests UNLESS an 83(b) election is made, in which case the holding period commences on the transfer date.

Technical Issues – Miscellaneous (cont'd)

- **Miscellaneous**
  - Pass-thru entities (partnerships, S corporations, RICs, and common trust funds) may own QSBS with their partners/members/shareholders receiving the benefit of any exclusion provided certain requirements are met:
    - (i) The entity must have held the QSBS for > 5 years and acquired it in a manner that would have given benefit to an individual AND
    - (ii) The taxpayer must have held the interest in the pass-through entity at all times from and after the date the pass-through entity acquired the QSBS.
    - Ex: Partnership AB holds QSBS which it acquired for $1,000,000 on Day 1. On Day 1, A owns 25% of Partnership AB. On Day 2, A purchases 25% of the interests in Partnership AB from B such that A owns 50% of the entity. On Day 3, Partnership AB sells the QSBS for $6,000,000. All applicable requirements are met for gain exclusion under 1202. In this situation, 50% of the $5,000,000 of gain [$2,500,000] would pass through to A, but A would only be able to exclude $1,250,000 of that because ½ of A's ownership in Partnership AB was acquired after the Partnership acquired the QSBS.

Technical Issues – Miscellaneous (cont'd)

- **Miscellaneous**
  - Off-setting short position
    - Gain exclusion is denied if taxpayer has an offsetting short position with respect to QSBS.
    - A taxpayer has an offsetting short position IF
      - (i) Taxpayer made a short sale of substantially identical property.
      - (ii) Taxpayer acquired to sell substantially identical property at a fixed price OR
      - (iii) To the extent provided in regulations, the Taxpayer has entered into a transaction which substantially reduces the risk of loss from holding such QSBS.
    - Election - Taxpayer can still exclude gain IF QSBS was held for 5 years prior to the offsetting short position AND the taxpayer elects to recognize gain as if the stock were sold on the date the offsetting short position arose.
    - Taxpayer includes anyone related to the taxpayer (within the meaning of 267(b) or 707(b)).

State Tax Considerations

	Wisconsin	Illinois*	D.C.*	Colorado*	North Carolina*	Texas*	Utah*
Conformity with IRC.	Weird. See next slide.	Yes. Illinois conforms to 1202. 35 ILCS 5/102.	Yes. D.C. conforms to 1202. D.C. Code s. 47-1803.02(a).	Yes. Colorado conforms to 1202. Colo. Rev. Stat. S. 39-22-104.	Yes. North Carolina conforms to 1202. N.C. Gen. Stat. s. 105-153.4(a).	No. Texas does not impose an individual income tax.	Yes. Utah conforms to 1202. Utah Code s. 59-10-103(1)(a)(I)(A).

- * Per BNA IRC Conformity Chart

State Tax Considerations (cont'd)

- **Wisconsin**
  - Partially follows 1202
    - No exclusion for QSBS acquired on or before December 31, 2013.
    - 50% exclusion for QSBS acquired on or after January 1, 2014 (Wis. Stat. s. 71.98(5)).
    - Report the ineligible exclusion as an adjustment to federal AGI on Schedule I (for individuals). Pub 103 Reporting Capital Gains and Losses for Wisconsin by Individuals, Estates, and Trusts -- January 2022.
  - Wisconsin separately provides tax benefits with respect to investments in "qualified Wisconsin businesses," which may allow a taxpayer to exclude or defer 100% of certain capital gains. (Wis. Stat. s. 71.05(25)-(26)).
    - *See* Thomas J. Nichols & James W. DeCleene, *Investing in Qualified Wisconsin Businesses: A Closer Look*, available at Business Law Section Blog: Investing in Qualified Wisconsin Businesses: A Closer Look: (wisbar.org).
    - Involves registering with the DOR among other requirements.

Appendix – Authorities Interpreting Code Sec. 1202

- Cases
  - *Holmes v. Comm'r*, T.C. Memo. 2012-251 (aff'd by 9th Cir. in 593 Fed. App'x. 693)
    - Taxpayer failed to report $2M+ dollars of gain from the sale of stock despite not having made an election to defer gain under 1045. It was unclear whether the stock was acquired at its original issue and whether the business met the active conduct requirement.
    - The Tax Court found insufficient the Taxpayer's general statement that the company never had > $50M in gross assets where the Taxpayer failed to introduce balance sheets or other financial documents to support that statement.
  - *Natkunanathan v. Comm'r*, T.C. Memo. 2010-15 (aff'd by 9th Cir. in 479 Fed. App'x 775)
    - Taxpayer had received options to purchase stock of his old employer, which became options to purchase stock of Intel after a merger of his old employer into Intel.
    - The Tax Court held that Taxpayer was not entitled to QSBS exclusion because (1) he introduced no evidence to support that the company was a QSBS, (2) he did not show he held QSBS for > 5 years, and (3) he held options, not stock.
  - *Owen v. Comm'r*, T.C. Memo. 2012-21
    - No 1045 deferral because the active conduct requirement was flunked. Taxpayer had deposited nearly $2M in cash to a company account and only used $150,000 of it to purchase inventory.
    - The presence of such a large proportion of the company's assets being cash meant that less than 80% of the company's assets were being used in the active conduct of a qualified trade or business.

Appendix – Authorities Interpreting Code Sec. 1202

- IRS Guidance
  - CCA 202204007 (Jan. 28, 2022) – Definition of "brokerage services"
    - Corporation operates a website on which potential lessees may use the website to make nonbinding reservations for the use of certain facilities at specified rental rates from facility lessors that are included in the website data base. Corporation has no authority to enter into or sign leases on behalf of the potential lessors or lessees. A legally binding rental agreement for the use of a facility does not arise until the potential lessor and the potential lessee enter into a lease agreement. Corporation's website will show a user that is considering leasing one or more facilities in a particular location the facilities in that area that are included in the website data base.
    - Potential lessees do not pay any fee to Corporation for the use of Corporation's website. Lessors pay in exchange for being listed on Corporation's website.
    - IRS ruled that the Corporation's activities extended beyond merely advertising and constituted "brokerage services."
    - In doing so, the IRS eschewed resort to some definitions of brokerage services under the Code (particularly 199A) and reasoned that, since 1202 is an exception from the general rule that all income be included in gross income, the exceptions to what businesses are qualified trades or businesses should be interpreted broadly.
    - In line with that broad interpretation, the IRS said that the definition of a "broker" under 6045 (information reporting) should apply. That definition refers to a "broker" as "any person who regularly acts as a middleman with respect to property or services (including real estate) that the Secretary determines should be subject to reporting."
    - Here, the Corporation went beyond providing "mere" advertising services and acted as an intermediary between the lessors and the lessees. While Corporation was paid a flat fee for listings, it also received commission fees.

Appendix – Authorities Interpreting Code Sec. 1202

- IRS Guidance (cont'd)
  - PLR 202221006 – Business that operates pharmacies is engaged in a qualified trade or business and is not involved in the performance of services in the field of health or have as its principal asset the skill/reputation of one of its employees. 1202(e)(3).
  - PLR 202144026 - Tech company develops and commercializes software to assist medical providers in providing medical treatment to patients was engaged in a qualified trade or business and was not involved in the performance of services in the field of health and did not have as its principal asset the skill/reputation of one of its employees. 1202(e)(3).
  - PLR 202125004 – Manufacturer of certain prescription products was engaged in a qualified trade or business and was not involved in the performance of services in the field of health and did not have as its principal asset the skill/reputation of one of its employees. 1202(e)(3).
  - PLR 202114002 - Business labeled as insurance agent/broker viewed as not engaging in "brokerage services," which IRS ruled should be interpreted according to its plain meaning, i.e., "one who acts as an intermediary: such as a: an agent who arranges marriages b: an agent who negotiates contracts of purchase and sale." IRS ruled that Business's role was not that of a mere intermediary because the Business was required to perform a number of admin services, including reporting incidents, claims, suits, and notices of loss to the insurance company. No attempt made to view a portion of the Business as qualified and a portion as unqualified. 1202(e)(3).

Appendix – Authorities Interpreting Code Sec. 1202

- IRS Guidance (cont'd)
  - PLR 201717010 - Develop of tool used to provide complete and timely information to healthcare providers was engaged in a qualified trade or business and was not involved in the performance of services in the field of health and did not have as its principal asset the skill/reputation of one of its employees. 1202(e)(3).
  - PLR 201636003 - Membership interests in an LLC that had converted from a corporation considered to be QSBS despite not formally being "stock". 1202(c), (f), and (h).
  - PLR 201603010 – PLR 201603014 - Conversion of corporation to LLC treated as Type F Reorg, and interests in the LLC continued classification as QSBS. 1202(h).
  - PLR 201436001 - Company commercialized experimental drugs and performed R&D functions considered engaged in a qualified trade or business not involved in the performance of services in the field of health or have as its principal asset the skill/reputation of one of its employees. 1202(e)(3).
  - PLR 200906009 - Taxpayer not allowed to make late election to defer gain under 1045 during course of audit.
  - PLR 200521021 - Taxpayer allowed to make late election to defer gain under 1045 prior to any examination by the Service.
  - PLR 9810010 - Proportionate amount of Controlled stock received in exchange for Distributing stock in 355 spin-off transaction viewed as QSBS.

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Questions?

3:10 – 4 p.m.

Employee Retention Credit: Do Your Clients Have a Refund Available?

Edward Zollars, CPA, *Tax Partner, Thomas, Zollars & Lynch, Ltd.*

Employee Retention Credit: Do Your Clients Have a Refund Available?

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Overview of the Various ERC Versions

Employee Retention Credit

Reality vs. Marketing

- No, not every business qualifies for a check equal to $26,000 per employee
- But many businesses who do clearly qualify for some amount of this credit have not filed for the credit
- Today we hope to help you
  - Keep your clients from falling for the “too good to be true” hard sell ERC “consultants” that may leave them exposed to major problems down the road
  - Identify any clients that should be filing for this credit

Key IRS Guidance to Review

- Notice 2021-20 – provides overall guidance on the credit. While tied to 2020 version, it applies to all other periods unless specifically changed by the law. So we start here.
- Notice 2021-23 – limited to impact for first six months of 2021 version of the ERTC
- Notice 2021-49 – second most important guidance, provides information on final ERTC versions but also clarifies issues for prior periods (including the no living relative rule)

2020 Employee Retention Credit (After CAA Changes)

Distress Period	Covered Wages	Claiming Credit
• Receipts < 50% of same quarter in 2019 until quarter after return to > 80% • Full or partial suspension	• 50% of wages and medical plan costs per employee up to $10,000 for 2020 • Not used for PPP forgiveness • If more than 100 full time employees in 2019, then cannot perform services	• Form 941-x is the only remaining option for 2020 credits • Statute would be open generally through April 15, 2024

Full/Partial Suspension

- See Section III.D of Notice 2021-20 for IRS position – some "ERC shops" are pushing positions far outside this guidance but not telling their customers
- Question 12 – Supplier issues – not all (or most) supply chain restrictions qualify as a partial suspension
- Question 13 – Customers stay at home – not a qualifying suspension
- Question 14 – Voluntary suspension by a business not a qualifying supension

Full/Partial Suspension

- Question 17 – If only closed/restricted for certain purposes, only a partial shutdown if
  - *More than a nominal portion* of the business is impacted *and*
  - Restriction has *more than a nominal effect on business operations* (mask and vaccine requirements don't qualify)
  - 10% safe harbors
- Note – must also show
  - Specific state/local order that imposed the restriction (and must be mandatory, not advisory)
  - Must document beginning and ending date of the restriction

2021 ERC Through June 30 (CAA)

Distress Period	Covered Wages	Claiming Credit
• Receipts <80% of same quarter in 2019 (can use prior quarter to test) • Full or partial suspension	• 70% of wages per employee and medical plan costs up to $10,000 for each quarter • Not used for PPP forgiveness • If more than 500 full time employees in 2019, then cannot perform services	• Form 941-x is the only remaining option for first 6 months of 2021 credits • Statute would be open generally through April 15, 2025

2021 ERC Through September 30 (ARPA)

Distress Period	Covered Wages	Claiming Credit
• Receipts <80% of same quarter in 2019 (can use prior quarter to test) • Full or partial suspension • Recovery startup business (began after 2/15/20)	• 70% of wages and medical plan costs per employee up to $10,000 for each quarter • Not used for PPP forgiveness • If more than 500 full time employees in 2019, then cannot perform services unless revenue down by over 90%	• Form 941-x is the only remaining option for quarter 3 2021 credits • Q4 could still use reduce deposits and advance refund • Statute would be open generally through April 15, 2025

2021 ERC Fourth Quarter (IIJA)

Distress Period	Covered Wages	Claiming Credit
• Recovery startup business (began after 2/15/20)	• 70% of wages and medical plan costs per employee up to $10,000 for each quarter • Not used for PPP forgiveness • If more than 500 full time employees in 2019, then cannot perform services unless revenue down by over 90%	• Q4 can still use reduce deposits and advance refund • Statute would be open generally through April 15, 2025

Change to 4th Quarter ERC Found in IIJA

- The Infrastructure Investment and Jobs Act removed the 4th quarter ERC for most employers
- Only recovery start-up businesses will receive the credit for the fourth quarter of 2021

Planning Concepts with the ERC

Employee Retention Credit

Keep in Mind

- Same dollar of wages cannot be used for ERC and loan forgiveness
- PPP forgiveness is more valuable than ERC but…don't want to use $1 more of ERC wages to get full PPP loan forgiveness than have to
  - Payroll costs should only be 60% of PPP loan unless have no other choice
  - Use non-wage payroll costs in full and also wages that don't qualify for ERC
    - Controlling interest shareholders and relatives
    - Wages in excess of $10,000
  - Maximize other expenses that qualify for the PPP on the application
- Also remember some other credits can't be used on ERC wages (research credit especially).

IRS Guidance Details

Employee Retention Credit

PPP Loan Forgiveness and the Gross Receipts Test

- Revenue Procedure 2021-33, 8/10/21
  - What to do with forgiveness as a gross receipts for
    - 50%/80% test for 2020
    - 20% test for 2021
  - IRS rules that PPP forgiveness does count as gross receipts
    - Congress references §448(c) whose regulations include tax exempt income
    - Would create a problem for many taxpayers, inflating gross receipts for the quarter when forgiveness is obtained.

From the Revenue Procedure

““Although the amount of forgiveness of a PPP Loan is not included in gross income, that forgiveness amount would be included in gross receipts under § 448(c) of the Code and § 1.448-1T(f)(2)(iv), or § 6033 of the Code and § 1.6033- 2(g)(4), as applicable. Similarly, the amount of an ERC-Coordinated Grant received by a taxpayer is not included in gross income, but the amount would be included in gross receipts.”

Example – PPP Proceeds as Gross Receipts

"TN, Inc. received a PPP loan of $200,000 in 2020. TN, Inc. has determined that the loan forgiveness income was triggered for income tax purposes on June 15, 2021. For the second quarter of 2021, TN, Inc. had gross receipts, other than receipts from forgiveness, of $750,000. In the second quarter of 2019, TN, Inc. had gross receipts of $1,000,000. With PPP forgiveness included in gross receipts for the second quarter of 2021, TN, Inc.'s gross receipts for that quarter under IRC §448(c) are $950,000, or 95% of the gross receipts for the same quarter in 2019. Thus, the amount is not less than 80% of the same quarter in 2019.

Assuming TN, Inc. was not subject to a full or partial shutdown in the second quarter of 2021 and that there was not a 20% drop in gross receipts from the first quarter of 2021 as compared with the first quarter of 2019, the inclusion of the PPP forgiveness in gross receipts would deny TN, Inc. the ability to claim the ERC in the second quarter of 2021. As well, it also could deny TN, Inc. any ERC in the third quarter of 2021, since TN, Inc. could not rely on a 20% drop in gross receipts in the immediately prior quarter to qualify for the ERC in the third quarter of 2021."

IRS Gives Taxpayers a Break

- Despite finding the amounts are gross receipts per the law, felt it was contrary to what Congress would want
  - Allow taxpayers to exclude PPP forgiveness, shuttered venue operator grants, and restaurant revitalization grants
  - Must do so consistently if elect to do so
  - Normally will be to the advantage of the employer to make this election
  - Can also reverse this election (though not sure why you would)?
- IRS likely feels they can do this because it is their regulation that had held tax-exempt income was part of gross receipts

Reason to Allow Per Revenue Procedure

"Section 2301(g) of the CARES Act and § 3134(h) of the Code set forth a coordination rule providing that the employee retention credit does not apply to so much of the qualified wages paid by an eligible employer as are taken into account as payroll costs in connection with forgiveness of a PPP Loan or, in the case of § 3134(h), an ERC-Coordinated Grant (relief programs). This rule demonstrates a congressional intent that an employer be able to participate in the relief programs and also claim the employee retention credit, provided that the same dollar of wages that are paid for or reimbursed with relief program funds may not be treated as qualified wages for purposes of the employee retention credit. Including the amount of the forgiveness of a PPP Loan or the amount of an ERC-Coordinated Grant in gross receipts for determining eligibility to claim the employee retention credit could frustrate this congressional intent."

Reason to Allow Per Revenue Procedure

"Specifically, an employer that participated in one or more of the relief programs and that otherwise has the requisite percentage decline in gross receipts might be precluded from claiming an employee retention credit with respect to a calendar quarter in which there is the decline in gross receipts solely because its participation in the relief program resulted in a temporary increase in gross receipts within the meaning of the tax law."

Example of Using the Safe Harbor

If TN, Inc. decides to elect the use of this Revenue Procedure, the company will now have gross receipts that are 75% of those in the same quarter in 2019 (750,000/1,000,000). Thus, TN, Inc. will qualify to claim the ERC in the second quarter of 2021 based on this decline.

As well, TN, Inc. will also automatically qualify to claim the ERC in the third quarter of 2021, since now the immediately preceding quarter had a greater than 20% decline in gross receipts.

Notice 2021-49 – Key ERC Guidance

Employee Retention Credit

Notice 2021-49, 8/4/21

- IRS guidance on
  - 3rd & 4th quarter ERC found now at IRC §3134
  - Open questions remaining about the ERC in general
- Second largest IRS guidance package on the ERC - initial package at Notice 2021-20 still is the largest package and applies to the extent not modified by later notices
  - Updated 2020 IRS FAQ and formalized it
  - The place to look for details on full and partial suspension of business
- Notice 2021-23 (released for 1st six months of 2021 ERC) from April applies as well to the extent it is consistent with 3rd & 4th quarter program

Related Parties and the ERC

- Guidance confirms what we had indicated was the plain text reading of the ERC's reference to IRC §51(i)(1)
- Creates the "no living relative" test
  - Note that the JCT has restated this conclusion in initial description of markup for reconciliation bill
  - Document x-43-21, page 178, regarding availability of WOTC per §51(i)(1)'s limits: "The credit is not allowed for wages paid to a relative or dependent of the taxpayer. No credit is allowed for wages paid to an individual who is a more than 50-percent owner of the entity."
  - This duplicates the PATH Act committee report we discussed in June 2 session-and is still really technically wrong, but right from a practical perspective for 99% of clients

Text of the Statutory Provisions

- CARES Act §2301(e): "For purposes of this section, rules similar to the rules of sections 51(i)(1) and 280C(a) of the Internal Revenue Code of 1986 shall apply."
- IRC §51(i)(1)(A): "No wages shall be taken into account under subsection (a) with respect to an individual who— (A) bears any of the relationships described in subparagraphs (A) through (G) of section 152(d)(2) to the taxpayer, or, if the taxpayer is a corporation, to an individual who owns, directly or indirectly, more than 50 percent in value of the outstanding stock of the corporation, or, if the taxpayer is an entity other than a corporation, to any individual who owns, directly or indirectly, more than 50 percent of the capital and profits interests in the entity (determined with the application of section 267(c)),…"

Text of the Statutory Provisions

- IRC §154(d)(2)(A)-(G): "(A)A child or a descendant of a child.
  (B) A brother, sister, stepbrother, or stepsister.
  (C) The father or mother, or an ancestor of either.
  (D) A stepfather or stepmother.
  (E) A son or daughter of a brother or sister of the taxpayer.
  (F) A brother or sister of the father or mother of the taxpayer.
  (G) A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law."

Text of the Statutory Provisions

- IRC §267(c): "(c)Constructive ownership of stock

  For purposes of determining, in applying subsection (b), the ownership of stock—

  (1) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries;

  (2)An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family;

  (3)An individual owning (otherwise than by the application of paragraph (2)) any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner;

Text of the Statutory Provisions

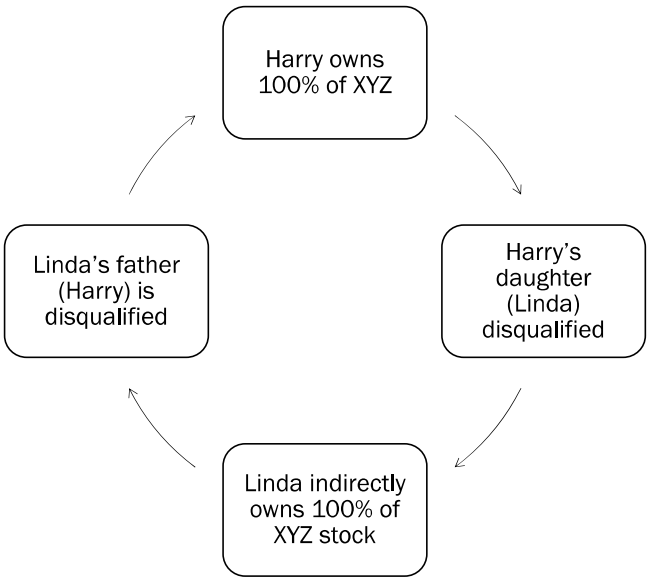
- IRC §267(c): "(c)Constructive ownership of stock

  For purposes of determining, in applying subsection (b), the ownership of stock—

  …

  (4)The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants; and

  (5)Stock constructively owned by a person by reason of the application of paragraph (1) shall, for the purpose of applying paragraph (1), (2), or (3), be treated as actually owned by such person, but stock constructively owned by an individual by reason of the application of paragraph (2) or (3) shall not be treated as owned by him for the purpose of again applying either of such paragraphs in order to make another the constructive owner of such stock.

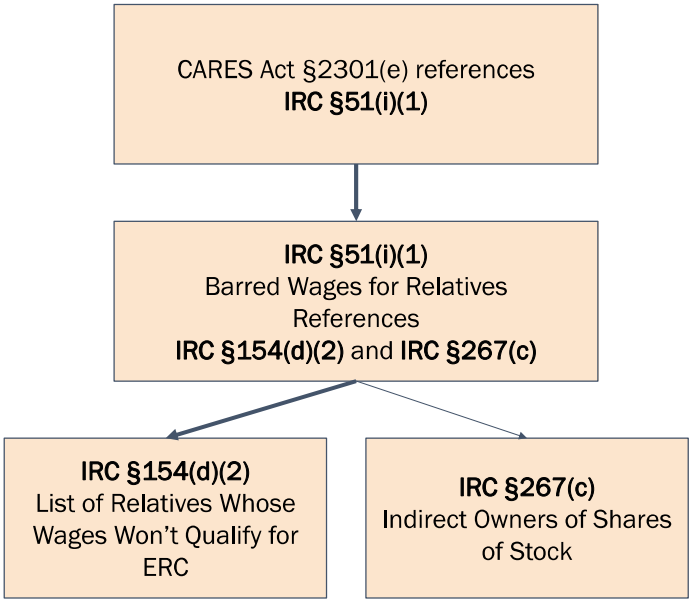


Applying the Rules

- Assume I own 100% of a corporation
- If my brother is an employee the corporation cannot claim a credit for his wages
  - I control the corporation (100% owner)
  - My brother has a relationship to me listed in §51(i)(1)

Applying the References

My brother is in my list of relatives so any wages to him will not qualify for ERC.



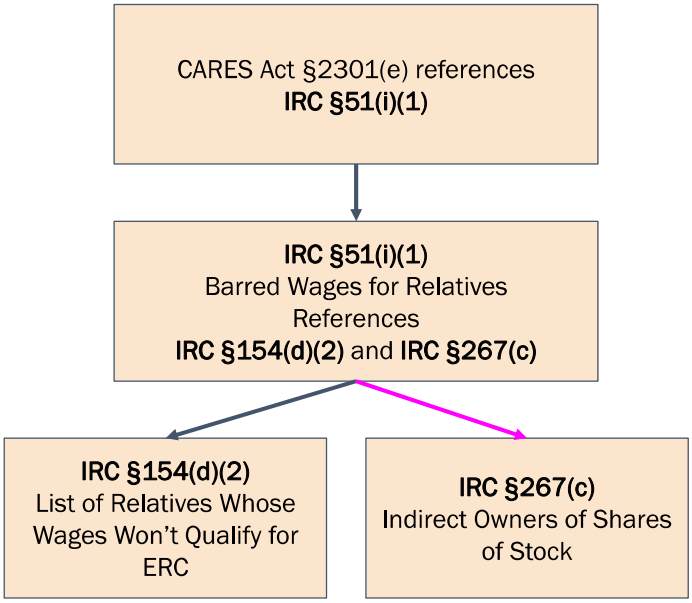
Applying the Rules

- My brother indirectly owns 100% of the corporation under §267(c)
- If his sister-in-law is employed by my corporation I'm also barred from claiming the credit
  - My brother indirectly owns 100% of my S corporation
  - His sister-in-law has an impermissible relationship to him
  - So corporation can't claim the credit

Applying the References

Under §267(c) my brother is treated as owner of 100% of shares

His sister-in-law is on his list of barred relatives, so her wages won't qualify for the ERC in my corporation.



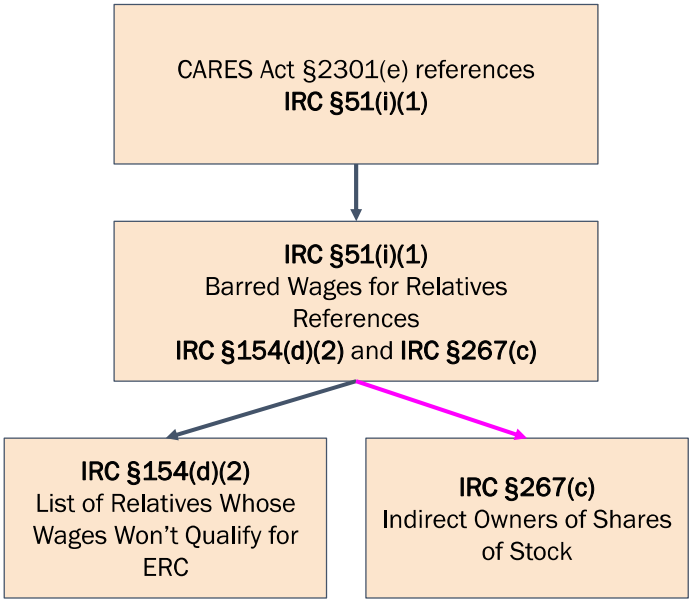
Applying the Rules

- But I have a similarly listed relationship to my brother
- So if I'm paid by my corporation (seems likely)
  - I'm the brother of an indirect 100% owner
  - Note this works even if my brother has nothing to do with my corporation--just needs to be alive

Applying the References

Again, my brother under §267(c) owns 100% of the stock.

And now I'm on the relative list for my brother, so wages paid to me are no longer eligible for



IRS Ruling Confirms This View

- Generally, wages paid to an individual (and their spouse) who owns interest that control over 50% of a corporation or partnership do not qualify for the ERC
  - Will be the case if there is a living §267(c) relative other than the spouse (ancestor, descendant, or sibling
  - Only if there is no living relative will these wages qualify
- The result is directly taken from the statute:
  - Ownership is "determined with the application of section 267(c).." §51(i)(1)(A)
  - Thus descendant, ancestor or sibling will end up constructively holding the same shares as the controlling interest holder (what §267(c) provides)
  - Controlling interest holder will be on the "relative list" from §152(d)(2)(A)-(G) of that constructive controlling owner.
  - *There is no ambiguity to be resolved, thus it matters not what "Congressional intent" was* (see Justice Thomas' opinion on that issue)

Connecticut National Bank v. Germain, 503 US 249, 253-254 (1992)

""In any event, canons of construction are no more than rules of thumb that help courts determine the meaning of legislation, and in interpreting a statute a court should always turn first to one, cardinal canon before all others. We have stated time and again that courts must presume that a legislature says in a statute what it means and means in a statute what it says there. See, e. g., *United States v. Ron Pair Enterprises*, Inc., 489 U. S. 235, 241-242 (1989); *United States v. Goldenberg*, 168 U. S. 95, 102-103 (1897); *Oneale v. Thornton*, 6 Cranch 53, 68 (1810). When the words of a statute are unambiguous, then, this first canon is also the last: "judicial inquiry is complete." *Rubin v. United States*, 449 U. S. 424, 430 (1981); see also Ron Pair Enterprises, supra, at 241.

Germain says that legislative history points to a different result. But we think that judicial inquiry into the applicability of § 1292 begins and ends with what § 1292 does say and with what § 158(d) does not."

Example 1 from Ruling – Parent and Child Shareholder

Corporation A is owned 80 percent by Individual E and 20 percent by Individual F. Individual F is the child of Individual E. Corporation A is an eligible employer with respect to the first calendar quarter of 2021. Both Individual E and Individual F are employees of Corporation A. Pursuant to the attribution rules of section 267(c) of the Code, both Individual E and Individual F are treated as 100 percent owners of Corporation A. Individual E has the relationship to Individual F described in section 152(d)(2)(C) of the Code, and Individual F has the relationship to Individual E described in section 152(d)(2)(A). Accordingly, Corporation A may not treat as qualified wages any wages paid to either Individual E or Individual F because both Individual E and Individual F are each related individuals for purposes of the employee retention credit.

Example 2 – Child Not Involved in Business

Corporation B is owned 100 percent by Individual G. Individual H is the child of Individual G. Corporation B is an eligible employer with respect to the first calendar quarter of 2021. Individual G is an employee of Corporation B, but Individual H is not. Pursuant to the attribution rules of section 267(c) of the Code, Individual H is attributed 100 percent ownership of Corporation B, and both Individual G and Individual H are treated as 100 percent owners. Individual G has the relationship to Individual H described in section 152(d)(2)(C) of the Code. Accordingly, Corporation B may not treat as qualified wages any wages paid to Individual G because Individual G is a related individual for purposes of the employee retention credit.

Example 3 – No Living Relative Rule

Corporation C is owned 100 percent by Individual J. Corporation C is an eligible employer with respect to the first calendar quarter of 2021. Individual J is married to Individual K, and they have no other family members as defined in section 267(c)(4) of the Code. Individual J and Individual K are both employees of Corporation C. Pursuant to the attribution rules of section 267(c), Individual K is attributed 100 percent ownership of Corporation A, and both Individual J and Individual K are treated as 100 percent owners. However, Individuals J and K do not have any of the relationships to each other described in section 152(d)(2)(A)-(H) of the Code. Accordingly, wages paid by Corporation C to Individual J and Individual K in the first calendar quarter of 2021 may be treated as qualified wages if the amounts satisfy the other requirements to be treated as qualified wages.

Example 4 – Sibling Owners

Corporation D is owned 34 percent by Individual L, 33 percent by Individual M, and 33 percent by Individual N. Individual L, Individual M, and Individual N are siblings. Corporation D is an eligible employer with respect to the first calendar quarter of 2021. Individual L, Individual M, and Individual N are employees of Corporation D. Pursuant to the attribution rules of section 267(c) of the Code, Individual L, Individual M, and Individual N are treated as 100 percent owners. Individual L, Individual M, and Individual N have the relationship to each other described in section 152(d)(2)(B) of the Code. Accordingly, Corporation D may not treat as qualified wages any wages paid to Individual L, Individual M, or Individual N.

Is This Notice Correct?

- My view – the reference to §267(c) defines who is an owner, which creates the splashback
- Congressional intent is not relevant in that case
- Even if it was, though
  - No evidence Congress did not intend splashback to work
  - Congress has twice put out committee reports indicating splashback exists in the ERC
    - The PATH Act report previously mentioned
    - Recent committee report on the House draft of the reconciliation bill
- Congress has the right to pass absurd laws…

Is This Notice Correct?

- But only the courts can say for sure.
- Filing position rules
  - If have reasonable basis authority under the §6662 regulations, can take position with disclosure
  - If you believe the authority is substantial authority, then (and only then) you can take without disclosure
- Should likely advise clients when taking a position not in line with the Notice and if already filed with a position contrary to this Notice.

Full Time Employees/Full Time Equivalents

- Although the law refers to the ACA employee definitions in the provision used for testing for ALE, don't use ALE number of "employees"
- The specific reference is only to the full time employees provision
- Thus full time equivalents do not count in determining the 500/100 employee count for average 2019 employees and the "large employer" classifications for ERC

Tips and §45B Credit

- Tips count was ERC wages despite the fact the employer does not pay them
- The law references wages per IRC §3121
  - That includes cash tips received by an employee
  - Only exception is if the total is $20 or less
- Same result takes place if tip credit claimed by employer under IRC §45B, as Congress did not put that credit in the list that bars the use of the ERC for the same wages

Timing of Deduction Disallowance

- ERC requires the employer to reduce the deduction for wages by the amount of ERC allowed on those wages
- IRS decides that this language requires going back to the year the wages were deducted on the income tax return
- Thus 2020 ERC refund claims will often require the taxpayer to amend a previously filed tax return that covered the quarter in question
- IRS does not provide a different result for those on the cash basis, so can't wait for the refund to be received

Alternative Quarter Election

- 2021 we started using a different reduced gross receipts calculation for ERC
- Also obtained option to test the prior instead of current quarter to qualify
- IRS rules that consistency is not required by the law
  - If elect prior quarter for Q1 2021 (that is, tested Q4 2020 vs. Q4 2021 to obtain 20% reduction)
  - Do not have to use Q1 2021 to see if qualify for Q2 2021 (so not a problem if Q1 2021's receipts are not down 20% from Q1 2019, so long as Q2 2021 shows that decrease vs. Q2 2019)
- Also means if have a 20% drop in Q1 or Q2 of 2021, will automatically qualify for at least two quarters, which is roughly what was true in 2020 (once you qualified in a quarter, you would be in through at least the next one)

Extended Statute of Limitations on Assessing Tax

- For the 3rd/4th quarter ERC, the IRS has five years to assess taxes related to ERC credits claimed
- This rule only applies to the 3rd/4th quarter - the standard three year period applies to other ERC credits
- Note that due to the longer statute, an employer who claimed too much for ERC may not be able to go back and claim a refund related to an increased wage deduction if the IRS comes in after the year the wages were paid is closed for a claim for refund for income tax purposes.

Questions?

Employee Retention Credit

4:10 – 5 p.m.

Hot Tax Practice Procedure & Ethical Issues

Michael Goller, J.D., *Shareholder & Tax Department Chair, Reinhart Boerner Van Deuren s.c.*

HOT TAX ETHICS, PRACTICE AND PROCEDURAL ISSUES

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Michael G. Goller is a shareholder in Reinhart's Tax, Litigation and Business practices. He focuses on tax controversy and tax litigation, as well as tax and estate planning. His clients range from large public corporations to midsized, privately held businesses and their owners. Michael works on behalf of his clients in disputes with the IRS, the Department of Justice and various other taxing authorities.

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Table of Contents

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PART I
Hot Practice and Procedure Issues

- The IRS is going to receive a lot of money. How will it be spent?
- What are the hot audit issues?

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Hot Issues - Which Will Get Hotter

- Partnership Audits
- High Net Worth Audits
- Estate and Gift - Valuation Issues
- Net Operating Loss and Basis Issues
- Passive Losses and the Real Estate Professional
- Section 183 – "Hobby" Loss Cases
- Refund Claim Traps
- Employment Tax Audits
- Penalty Issues

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PARTNERSHIP AUDITS

New Partnership Audit Program and related high net worth audit program are HOT in FY 2022, and beyond.

Source: Tax Notes (9/20/21)

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Overview

The BBA, among other things, eliminates the so-called TEFRA Unified Partnership Audit Procedures[1] and the Audit Procedures for Electing Large Partnerships.[2] It also creates a more streamlined partnership audit approach, thus making it easier for the IRS to audit a partnership.

1 These were first created in the Tax Equity and Responsibility Act of 1982.
2 Created as part of the Taxpayer Relief Act of 1997.

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Neutral Revenue Raiser

- The BBA was promoted as a "neutral" revenue raiser (*i.e.*, a revenue raiser in disguise); in that an increase in partnership audits will raise revenue without increasing taxes.
- It is expected that the new audit procedures and increased audits will yield $9.3 billion of additional revenue over ten years. As such, the law gained quick approval in Congress.

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Partnership Audit Road Map

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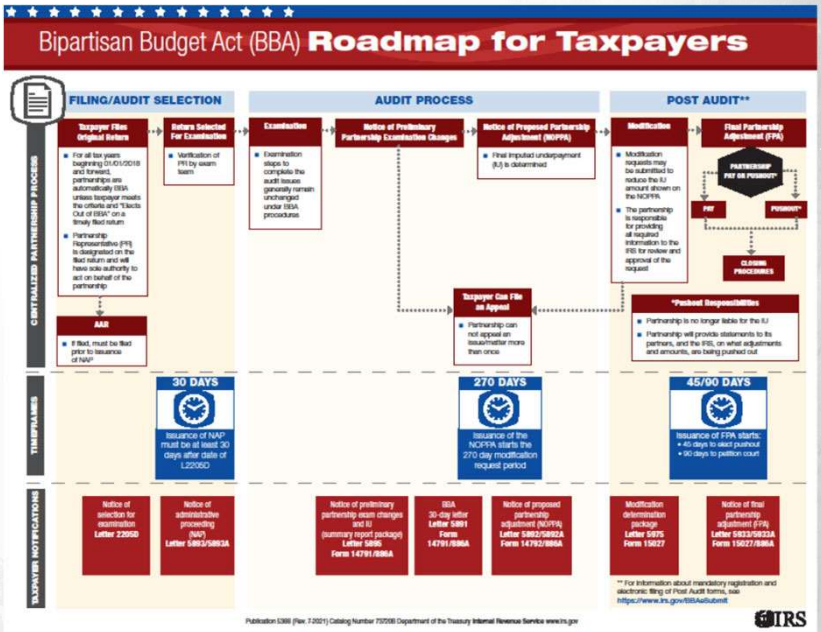

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Current Status

- These audits seem to be off to a slow start
- IRS is asking for lengthy statute extensions

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Airplane Cases

- Partnership or corporate structure
  - Personal Entertainment v. Non-Personal Entertainment
- SIFL or §274-10(e)
- Schedule C Structure – CCA 202117012 (4/30/21)
- Depreciation and the Section 280F trap
- Entertainment Facility trap

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Auditing Net Operating Losses

- What are the rules of the road
- Many traps – the statute of limitations is an issue

Comment: The five year net operating loss carry back has made this very relevant

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Statute of Limitations Issues

- A statute of limitations is a law that specifies the amount of time within which an act must be performed to be legally binding.
- Normally, the IRS must make any assessment of additional tax within three years of the time a return is filed.
- Assessment is nothing more than a bookkeeping entry made on the records of the Internal Revenue Service. Specifically, section 6203 provides that an "assessment shall be made by recording the liability of the taxpayer in the Office of the Secretary [of the Treasury] . . . ."
- A determination as to when the IRS made an assessment can be made by reviewing an IRS transcript of account.

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Statute of Limitations Issues (cont.)

There are a few significant intricacies about the statute of limitations on assessment

A. A return filed prior to the due date is treated as filed on the due date
B. If the return is filed after the due date, then the actual date of filing is used
C. A return required to be filed return is deemed filed when it is postmarked, if the return is timely filed
D. If the return is not filed when due, then the filing date, for limitations purposes, is the date it is actually received by the IRS. When a return is filed with the wrong Service Center, the statute does not begin to run until the redirected return is received by the correct Service Center

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Statute of Limitations Issues (cont.)

E. When calculating the 3-year period, the date that the return is actually filed is excluded
F. When the due date falls on a Saturday, Sunday, or legal holiday, the return is considered timely filed if it is filed on the next business day. In such an instance, the statute of limitations begins to run on the actual date of filing.
G. The statute of limitations on assessing estate tax cannot be extended. See § 6501(c)(4)(A)

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Exception to Three-Year Rule for Items Carried Forward or Back

A. A deficiency attributable to the carry-forward of a net operating loss, capital loss, or unused tax credit may be assessed within 3 years of the date of filing the return for the year the loss or credit is used, even though such date may be well beyond the normal statute of limitations for the year to which the loss or credit originally arose

B. The statute of limitations on a carryback runs from the year of the loss, not the year in which the benefit of the loss is put to use

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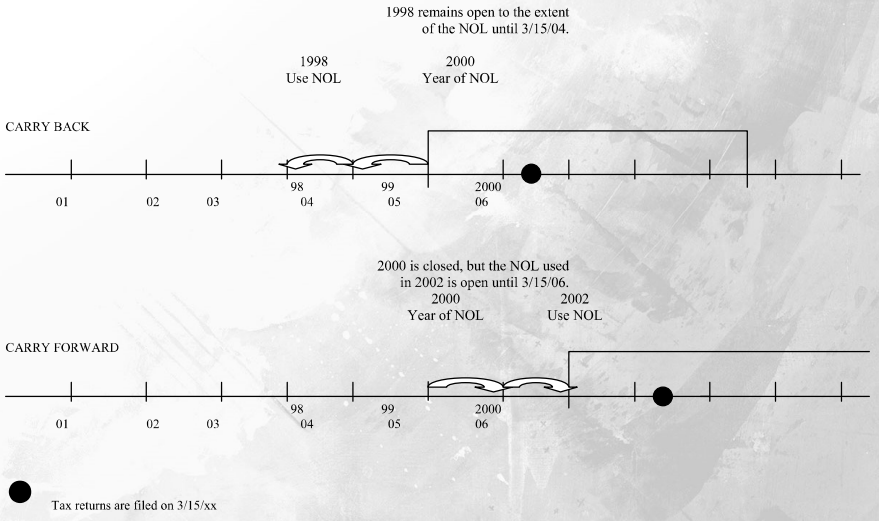
Net Operating Losses and The Statute of Limitations on Assessment § 6501



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IRS Attach on Cost Segregation Studies

- Publication 5653 (Rev. 6-2022) "Cost Segregation and Audit Technique Guide"
- Revisions were not large but whenever the IRS revises an audit manual, there will be audits

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Sample IDR

Form 4564 | Department of the Treasury, Internal Revenue Service, Information Document Request | Request Number 006

To: [redacted]

Subject: Activity Log

Submitted to: [redacted]

Dates of Previous Requests: N/A

Description of Documents Requested:

1. Please complete and sign the attached log forms (Exhibit A for calendar year 2019 and Exhibit B for calendar year 2020) for each real estate activity for which Taxpayer claims to have materially participated.
   a. List all hours and services performed for the 2019 and 2020 calendar years. Provide detailed explanations of services or activities performed.
   b. Provide documents to support hours claimed. This can include, but is not limited to, calendars, diaries, or other documents that reflect services provided and hours attributable to those services.

Where documents exist in electronic format, please provide in original electronic format.

Draft Date: 9/16/2022
Due Date: 11/7/2022

Information Due By 11/7/22 At Next Appointment ☐ Mail In ☐

	Name and Title of Requestor: Hwang, Yujin, Internal Revenue Agent	Badge Number: 1003822997 Phone: 312-292-3152 Fax: 855-330-7359 Email: Yujin.hwang@irs.gov	Date: 9/16/2022
FROM	Office Location: Internal Revenue Service; Mail Stop 4171 LB&I:ECPA:1113; 230 S. Dearborn; Chicago, IL 60604		Page 1 of 1

Form 4564

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Passive Losses and the Real EstateProfessional

- Section 469
- Rental Real Estate
- Real Estate Professional
- Proving Material Participation
- Make a Grouping Election – watch limited partnership trap

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Section 183 "Hobby" Loss Cases

- Section 183
- Recent case - Walters v. Comm'r, T.C. Memo 2022-17 "Green Home" was a for profit venture

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PART II
The Very Hot Research Credit

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The Section 41 Research Credit

- Background of the Research Credit
- Different types of Research Credits
  - Regular Credit--20% of current year's expenses over base period expenses. Must prove up fixed base percentage.
  - Alternative Simplified Credit--credit ranges from 1.65% to 3.75% and is a function of three prior years' sales

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The four tests:

- Elimination of Uncertainty for each New or Improved Business Component Test
- Technological in Nature Test--discover information that is technological
- Process of Experimentation Test--Experiment in the "scientific" sense
- Business Component Test--needs some level of functional improvement to a new or improved Business Component

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Examples

- Software development
- Improving the manufacturing process
- New technology exploration
- A great deal of manufacturing can qualify, but look closely at the four tests

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IRS Concerns

- A great deal of manufacturing can qualify, but look closely at the four tests
- IRS believes there is widespread abuse
- Discovery Requests- very broad
- A Second (or Third) Tour – very common
- Funded Research – a hot issue
- Base Period Substantiation-Traditional Credit
- IRS "Upping the Ante" by Amending the IRS's Tax Court Answer to Disallow all QRE and Assert a Penalty
- New IRS policy on refund claims

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Uncertainty Test

- "Activities intended to discover information that would eliminate uncertainty concerning the development of improvement of a product."
- Uncertainty exists if the information available to the taxpayer at the start of the project does not establish the method of improving or designing the component.
- Uncertainty must be as to technical ability, not economic or business uncertainty.
- Focus is on activities being conducted to address the uncertainty.

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Technological in Nature Test

- "Activities undertaken for the purpose of discovering information which is *technological in nature*."
  - Technological in Nature
    - Relies on the principles of hard sciences, such as engineering and physical, biological, or computer sciences.
    - May apply existing technologies or principles to eliminate uncertainty.
    - Patent safe harbor- rebuttable presumption that test is met if there is a patent.

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Process of Experimentation Test

- Substantially all (i.e. 80%) of the activities constitute a process of experimentation.
- Hypothesis, Test, Retest
  - Factors indicating experimentation:
    - Testing and analyzing alternative hypotheses
    - Significant scientific testing, and
    - Evaluation of numerous of complex technical tests

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Business Component Test

- Development of a product and/or process
- A business component is “a product, process, computer software, technique, formula, or invention” that is held for sale, lease or license or is used by the taxpayer in a trade or business.
- Section 41(d)(2)(B)
- Research relating to process improvements must qualify separately from the research relating to the product produced
- There must be some level of functional improvement
- Shrink Back Rule
  - If an entire product or process does not meet the test, the components of the product or process may be considered and some of the costs may qualify.

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IRS Exam, Appeals and Litigation Process

- Involvement of the examination function at appeals is now common
- IRS "engineer"--often not an engineer
- Hazards of litigation
- Document IRS concessions (i.e., the "engineer" agrees an item has been documented)
- IRS attorney will often try to raise a "New Issue“ (i.e., a penalty, funded research, disallow all QRE, look closer at the “Substantially All” test

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The IRS "Engineer"

- May not be an engineer
- Often "drives the bus"

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Good Credit Study

- Allocate costs by New or Improved Business Component
- Avoid repeated "boiler plate" language
- Study should summarize findings, not repeat statements (hearsay issue)
- The author of the credit study summarizes his or her investigation and then opines that:
  - The four tests are met
  - None of the exclusions apply (e.g., funded research or undocumented contract research)

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IRS Standard Information Document Request ("IDR") Traps

- The IRS typically issues a "standard" IDR in all research credit cases. Think about these questions before the return is filed.
- Traps to watch for
- Don't confuse "Projects" with "New or Improved Business Components"
  - Each New or Improved Business Component must meet the four tests
- Each question is a potential trap/admission

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The IRS Tour

- Usually a Fishing Expedition
- IRS Insists on These in Most Cases
- Manage the Interview – witness prep is key

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Witness Tips-Research Credit Cases

Explain the Following to the Witness

- To qualify for the R&D credit, activities must meet all of the following four tests.
  - **Elimination of Technical Uncertainty** – The research is intended to **eliminate technical uncertainty** as it relates to any of the following:
    - Capability uncertainty – can we do what is asked?
    - Methodology uncertainty – how will we do what is asked?
    - Design uncertainty – can we design the actual solution?

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Witness Tips-Research Credit Cases (cont.)

- **Technological in Nature** – The research must be designated to discover information that is **"technological in nature"**. The research activities must rely on the **principals of science, such as engineering, physical, biological, or computer science**.

- **Process of Experimentation** – The research must involve a process of **experimentation** intended to eliminate the technical uncertainty (**hypothesis**, test, retest).

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Witness Tips-Research Credit Cases (cont.)

- **New or Improved Business Component** – The research must be intended to develop or improve the **performance, function, quality, or reliability of a product, process or system** (i.e. new of **improved business component**).

Common Interview Questions/Themes

General

- What is your educational/technical background?
- What was your role on the project? The IRS is looking to disqualify wages not related to the research activities (e.g., sales, day-to-day operational support, management activities).
- How did you calculate the research expenses (e.g., time tracking system, calendar meetings, other records)?
- Do you contract with third parties who perform research?
- Maintenance activities can be research activities-but you may need to explain this.

Common Interview Questions/Themes (cont.)

- Business Component (i.e., project) specific questions:
  - What was the goal of the project?
  - What were the specific research activities?
  - What were the steps in the development of the new or improved product, process, or system?
  - Why was there uncertainty
  - When did research cease (i.e., when was the technical uncertainty eliminated?)?
  - Wasn't this just "pure math"

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Common Interview Questions/Themes (cont.)

- What risk of loss existed when you undertook this research
- What rights did you retain in your research (be prepared to address language in a contract)

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Tips for Answering Questions

- **Don't minimize your involvement in research projects.** This is not a time for humility.
- **Provide specific examples of your technical involvement in research projects.**
- Avoid words and phrases like "**tweak**," "**refigure**," "**modify**," "**we know we could do it**"
- Mention specific challenges, problems, obstacles, uncertainties, and failures (**failure is a good thing for purposes of the credit**) and the steps undertaken to try to arrive at a solution (e.g., hypothesis, testing, retesting, prototyping, modeling).

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Tips for Answering Questions (cont.)

- Mention the risk of loss you faced
- Words and phrases like "**scientific**," "**uncertainty**," "**test and retest**," "**measure data**," "**solution**," "**new or improved product**," "**new or improved process**," "**new or improved system**" are helpful
- It's OK to say "I don't know, we will get back to you"
- Be honest
- Avoid going off topic

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IRS Acknowledgement IDR-- Happens at the end of the audit

- IRS issues to most LB&I taxpayers an IDR that attempts to box the taxpayer into certain facts
- How to respond to the IDR?
- Why noncompliance is not an option:
  - Burden of proof issues
  - Rule of evidence issues (must make info available to opponent)
  - Penalty issues--arguing reasonable cause
  - IRS appeals uses a nonresponse as a basis for not appealing
  - Qualified Offer issues

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Cooperation Issues

- Consider if you are eligible to switch the burden of proof to the IRS
  - Cooperation is important
  - Adequate records are important
- Noncooperation leads to admissions (e.g., statements or inferences that are later used against you)

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Acknowledgement IDR

- Use the acknowledgement IDR to support your case

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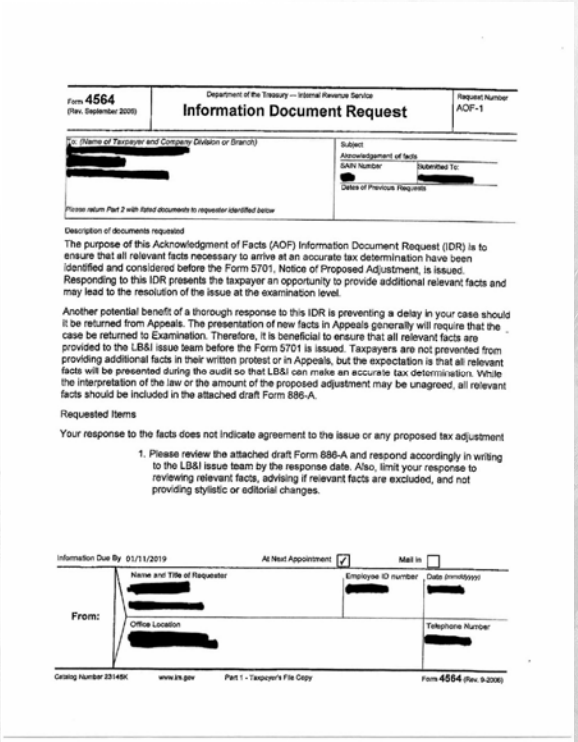

Form 4564 (Rev. September 2005)

Department of the Treasury — Internal Revenue Service

Information Document Request

Request Number: AOF-1

To: (Name of Taxpayer and Company Division or Branch)
[redacted]

Subject: Acknowledgement of facts
SAIN Number: [redacted]
Submitted To: [redacted]
Dates of Previous Requests:

Please return Part 2 with listed documents to requester identified below

Description of documents requested

The purpose of this Acknowledgment of Facts (AOF) Information Document Request (IDR) is to ensure that all relevant facts necessary to arrive at an accurate tax determination have been identified and considered before the Form 5701, Notice of Proposed Adjustment, is issued. Responding to this IDR presents the taxpayer an opportunity to provide additional relevant facts and may lead to the resolution of the issue at the examination level.

Another potential benefit of a thorough response to this IDR is preventing a delay in your case should it be returned from Appeals. The presentation of new facts in Appeals generally will require that the case be returned to Examination. Therefore, it is beneficial to ensure that all relevant facts are provided to the LB&I issue team before the Form 5701 is issued. Taxpayers are not prevented from providing additional facts in their written protest or in Appeals, but the expectation is that all relevant facts will be presented during the audit so that LB&I can make an accurate tax determination. While the interpretation of the law or the amount of the proposed adjustment may be unagreed, all relevant facts should be included in the attached draft Form 886-A.

Requested Items

Your response to the facts does not indicate agreement to the issue or any proposed tax adjustment

1. Please review the attached draft Form 886-A and respond accordingly in writing to the LB&I issue team by the response date. Also, limit your response to reviewing relevant facts, advising if relevant facts are excluded, and not providing stylistic or editorial changes.

Information Due By: 01/11/2019 At Next Appointment ☑ Mail in ☐

From: Name and Title of Requester [redacted] | Employee ID number [redacted] | Date (mm/dd/yyyy) [redacted]
Office Location [redacted] | Telephone Number [redacted]

Catalog Number 23145K www.irs.gov Part 1 - Taxpayer's File Copy Form 4564 (Rev. 9-2005)

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Form 4564 (Rev. September 2006)

Department of the Treasury -- Internal Revenue Service

Information Document Request

Request Number: AOF-1

2. Please check the box(es) that apply:

a. ☐ The taxpayer agrees that all relevant facts are documented in the attached draft Form 886-A.

b. ☐The taxpayer does not agree with specific facts documented in the draft Form 886-A. The taxpayer will identify the specific facts that are in dispute, and will provide documents to support those specific facts by the response date of this IDR that will permit the issue team to make an accurate tax determination.

c. ☐ The taxpayer does not agree that all relevant facts are documented in the draft Form 886-A. The taxpayer will identify all omitted relevant facts, will provide the documents upon which the taxpayer relied to support those additional facts that will permit the issue team to make an accurate tax determination, and will provide the additional facts by the response date of this IDR.

d. ☐ Other, please explain.

Information Due By 01/11/2019 At Next Appointment ☑ Mail In ☐

From: Name and Title of Requester [redacted], Internal Revenue Agent | Employee ID number [redacted] | Date (mm/dd/yyyy) [redacted]

Office Location [redacted] | Telephone Number [redacted]

Catalog Number 22145K www.irs.gov Part 1 - Taxpayer's File Copy Form 4564 (Rev. 9-2006)

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Form 886-A (Rev. January 1994)

Department of the Treasury - Internal Revenue Service

Explanation of Items

Page 1 of 9

Issue No.

Name of Taxpayer [redacted]

Tax Identification Number [redacted]

Year/Period Ended 201612-201712

IRC 41 – Credit for Increased Research Activities

A taxpayer may claim credit for certain increased research or experimental activities in connection with its trade or business. Research or experimental expenditures are expenditures incurred in the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense (for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product). The computation of the Research Credit ("RC") is based upon Qualified Research Expenditures ("QREs"), specifically defined as wages, supplies, and contract research incurred in the research process.

Issue

In tax years 201612 - 201712 for [redacted] were the expenses used to compute the Research Credit, and the Credit amount correct and in accordance with IRC §41?

No. The correct Research Credit amounts for increasing research activities are reflected in the following table.

	2016	2017
Credit per Return	$ [redacted]	$ [redacted]
per IRS Audit	$ -	$ -
Adjustments to Credit	$ [redacted]	$ [redacted]

Please note the above credit amounts were determined using the Alternative Simplified Credit. The IRC § 280c reduced credit election was made in both years.

I, [redacted], IRS Engineer, wrote this report.

Form 886-A Department of the Treasury - Internal Revenue Service

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Form 886-A	Explanation of Items	Page 2 of 9
Name of Taxpayer [redacted]	Tax Identification Number [redacted]	Issue No. Year/Period Ended 201612-201712

Facts

[redacted] was founded in [redacted] designs and manufactures [redacted]

When this case was first assigned as a consultation the focus was on 201612. As the audit progressed the IRS audit team decided to add the 201712 tax year as well. For the tax years 201612 and 201712, [redacted] prepared the [redacted] returns, conducted a Research Credit study and aided in the credit computations.

On September 21, 2018, [redacted] provided a tour of their facility [redacted] WI to gain a better understanding of its operations and the extent of research conducted. In addition, we interviewed [redacted] to understand how jobs/projects are taken from order receipt to passing the necessary components along to the construction contractor for installation at the customer site.

[redacted] does not track QREs by project, instead [redacted] determines qualified wages on an employee-by-employee basis. [redacted] evaluate projects, activities and costs to make determinations on the what percentage is appropriate given the law under IRC Section 41.

The following table summarizes the recent QRE history of [redacted]

	2013	2014	2015	2016	2017
Wages	[redacted]				
Supplies	-	-	-	-	-
Contract Research	[redacted]				
Total QREs	[redacted]				

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Form 886-A	Explanation of Items	Page 3 of 9
Name of Taxpayer [redacted]	Tax Identification Number [redacted]	Issue No. Year/Period Ended 201612-201712

Applicable Law

Section 41(b)(1) provides that the term "qualified research expenses" means the sum of the following amounts which are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business of the taxpayer: (A) in-house research expenses; and (B) contract research expenses.

Section 41(b)(2) provides, in relevant part, that in-house research expenses include any wages paid or incurred to an employee for "qualified services" performed by such employee, and any amount paid or incurred for supplies used in the conduct of qualified research.

Section 41(b)(2)(B) provides that qualified services means, for purposes of both in-house and contract expenses, (i) engaging in qualified research, or (ii) engaging in the direct supervision or direct support of research activities which constitute qualified research.

Treas. Reg. §1.41-2(c)(1) provides that engaging in qualified research for purposes of performing qualified services means the actual conduct of qualified research (as in the case of a scientist conducting laboratory experiments).

Treas. Reg. §1.41-2(c)(2) provides that direct supervision for purposes of performing qualified services means the immediate supervision (first-line management) of qualified research (as in the case of a research scientist who directly supervises laboratory experiments, but who may not actually perform experiments). Direct supervision does

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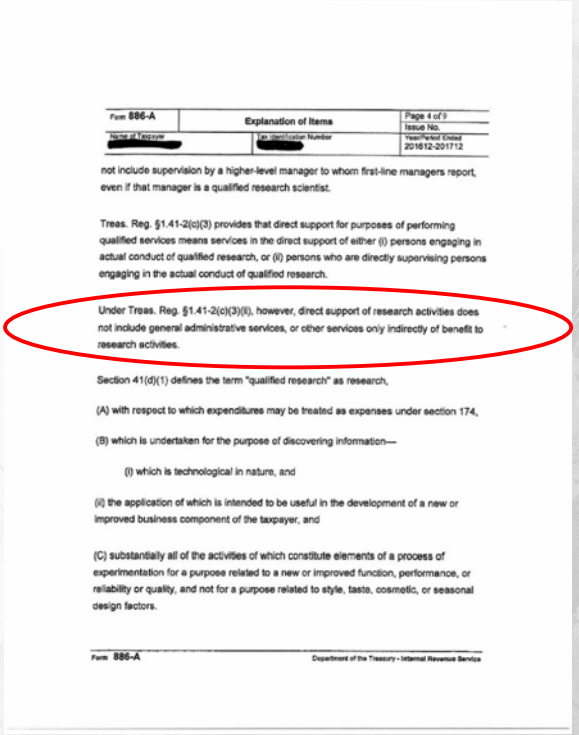

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Name of Taxpayer [redacted] | Tax Identification Number [redacted] | Year/Period Ended 201612-201712

not include supervision by a higher-level manager to whom first-line managers report, even if that manager is a qualified research scientist.

Treas. Reg. §1.41-2(c)(3) provides that direct support for purposes of performing qualified services means services in the direct support of either (i) persons engaging in actual conduct of qualified research, or (ii) persons who are directly supervising persons engaging in the actual conduct of qualified research.

Under Treas. Reg. §1.41-2(c)(3)(ii), however, direct support of research activities does not include general administrative services, or other services only indirectly of benefit to research activities.

Section 41(d)(1) defines the term "qualified research" as research,

(A) with respect to which expenditures may be treated as expenses under section 174,

(B) which is undertaken for the purpose of discovering information—

(i) which is technological in nature, and

(ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and

(C) substantially all of the activities of which constitute elements of a process of experimentation for a purpose related to a new or improved function, performance, or reliability or quality, and not for a purpose related to style, taste, cosmetic, or seasonal design factors.

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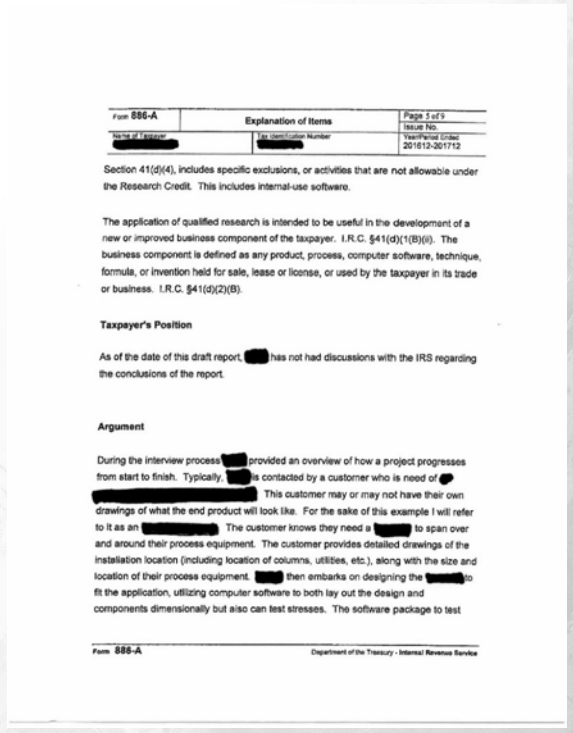

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Name of Taxpayer [redacted] | Tax Identification Number [redacted] | Year/Period Ended 201612-201712

Section 41(d)(4), includes specific exclusions, or activities that are not allowable under the Research Credit. This includes internal-use software.

The application of qualified research is intended to be useful in the development of a new or improved business component of the taxpayer. I.R.C. §41(d)(1(B)(ii). The business component is defined as any product, process, computer software, technique, formula, or invention held for sale, lease or license, or used by the taxpayer in its trade or business. I.R.C. §41(d)(2)(B).

Taxpayer's Position

As of the date of this draft report, [redacted] has not had discussions with the IRS regarding the conclusions of the report.

Argument

During the interview process [redacted] provided an overview of how a project progresses from start to finish. Typically, [redacted] is contacted by a customer who is need of [redacted] This customer may or may not have their own drawings of what the end product will look like. For the sake of this example I will refer to it as an [redacted] The customer knows they need a [redacted] to span over and around their process equipment. The customer provides detailed drawings of the installation location (including location of columns, utilities, etc.), along with the size and location of their process equipment. [redacted] then embarks on designing the [redacted] to fit the application, utilizing computer software to both lay out the design and components dimensionally but also can test stresses. The software package to test

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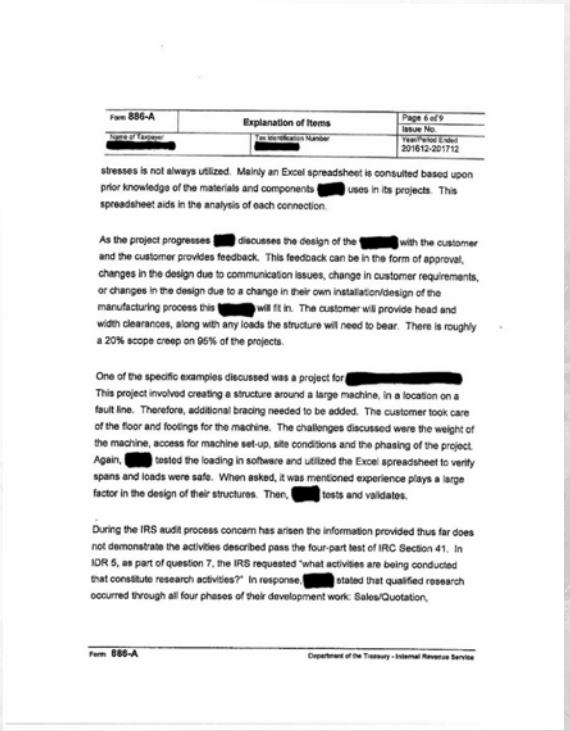

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Name of Taxpayer [redacted]	Tax Identification Number [redacted]	Issue No. Year/Period Ended 201612-201712

stresses is not always utilized. Mainly an Excel spreadsheet is consulted based upon prior knowledge of the materials and components [redacted] uses in its projects. This spreadsheet aids in the analysis of each connection.

As the project progresses [redacted] discusses the design of the [redacted] with the customer and the customer provides feedback. This feedback can be in the form of approval, changes in the design due to communication issues, change in customer requirements, or changes in the design due to a change in their own installation/design of the manufacturing process this [redacted] will fit in. The customer will provide head and width clearances, along with any loads the structure will need to bear. There is roughly a 20% scope creep on 95% of the projects.

One of the specific examples discussed was a project for [redacted] This project involved creating a structure around a large machine, in a location on a fault line. Therefore, additional bracing needed to be added. The customer took care of the floor and footings for the machine. The challenges discussed were the weight of the machine, access for machine set-up, site conditions and the phasing of the project. Again, [redacted] tested the loading in software and utilized the Excel spreadsheet to verify spans and loads were safe. When asked, it was mentioned experience plays a large factor in the design of their structures. Then, [redacted] tests and validates.

During the IRS audit process concern has arisen the information provided thus far does not demonstrate the activities described pass the four-part test of IRC Section 41. In IDR 5, as part of question 7, the IRS requested "what activities are being conducted that constitute research activities?" In response, [redacted] stated that qualified research occurred through all four phases of their development work: Sales/Quotation,

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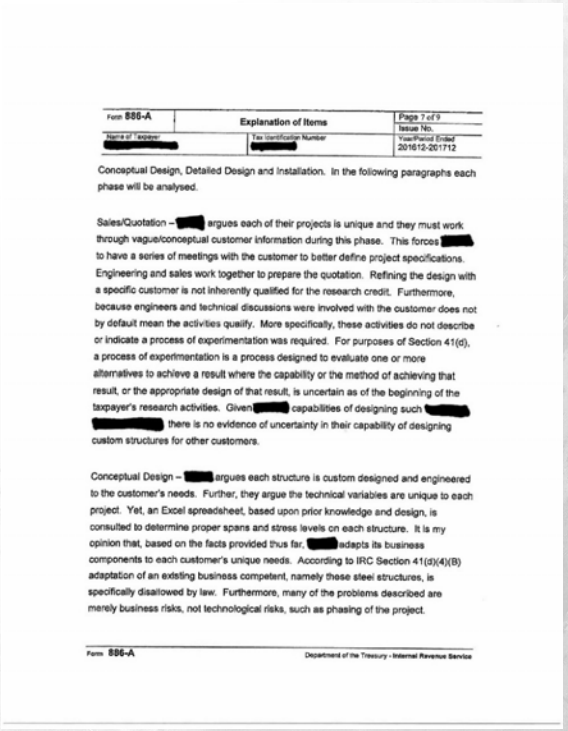

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Name of Taxpayer [redacted]	Tax Identification Number [redacted]	Issue No. Year/Period Ended 201612-201712

Conceptual Design, Detailed Design and Installation. In the following paragraphs each phase will be analysed.

Sales/Quotation – [redacted] argues each of their projects is unique and they must work through vague/conceptual customer information during this phase. This forces [redacted] to have a series of meetings with the customer to better define project specifications. Engineering and sales work together to prepare the quotation. Refining the design with a specific customer is not inherently qualified for the research credit. Furthermore, because engineers and technical discussions were involved with the customer does not by default mean the activities qualify. More specifically, these activities do not describe or indicate a process of experimentation was required. For purposes of Section 41(d), a process of experimentation is a process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer's research activities. Given [redacted] capabilities of designing such [redacted] there is no evidence of uncertainty in their capability of designing custom structures for other customers.

Conceptual Design – [redacted] argues each structure is custom designed and engineered to the customer's needs. Further, they argue the technical variables are unique to each project. Yet, an Excel spreadsheet, based upon prior knowledge and design, is consulted to determine proper spans and stress levels on each structure. It is my opinion that, based on the facts provided thus far, [redacted] adapts its business components to each customer's unique needs. According to IRC Section 41(d)(4)(B) adaptation of an existing business competent, namely these steel structures, is specifically disallowed by law. Furthermore, many of the problems described are merely business risks, not technological risks, such as phasing of the project.

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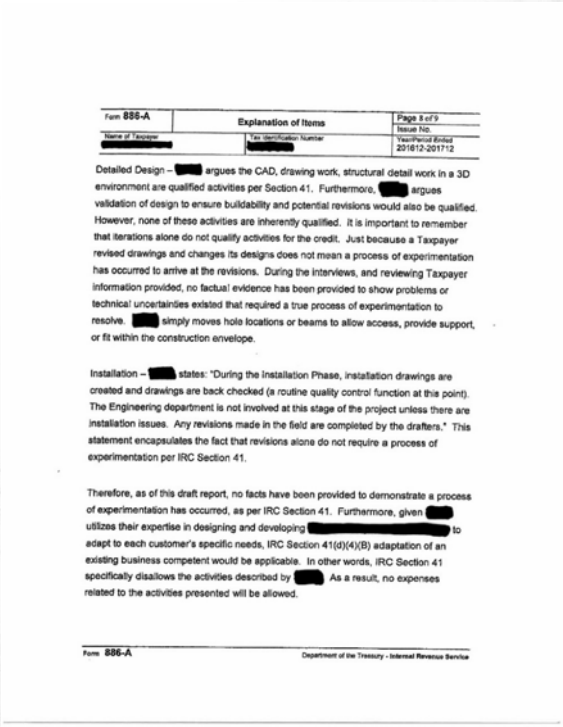

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Detailed Design – [redacted] argues the CAD, drawing work, structural detail work in a 3D environment are qualified activities per Section 41. Furthermore, [redacted] argues validation of design to ensure buildability and potential revisions would also be qualified. However, none of these activities are inherently qualified. It is important to remember that iterations alone do not qualify activities for the credit. Just because a Taxpayer revised drawings and changes its designs does not mean a process of experimentation has occurred to arrive at the revisions. During the interviews, and reviewing Taxpayer information provided, no factual evidence has been provided to show problems or technical uncertainties existed that required a true process of experimentation to resolve. [redacted] simply moves hole locations or beams to allow access, provide support, or fit within the construction envelope.

Installation – [redacted] states: "During the Installation Phase, installation drawings are created and drawings are back checked (a routine quality control function at this point). The Engineering department is not involved at this stage of the project unless there are installation issues. Any revisions made in the field are completed by the drafters." This statement encapsulates the fact that revisions alone do not require a process of experimentation per IRC Section 41.

Therefore, as of this draft report, no facts have been provided to demonstrate a process of experimentation has occurred, as per IRC Section 41. Furthermore, given [redacted] utilizes their expertise in designing and developing [redacted] to adapt to each customer's specific needs, IRC Section 41(d)(4)(B) adaptation of an existing business competent would be applicable. In other words, IRC Section 41 specifically disallows the activities described by [redacted]. As a result, no expenses related to the activities presented will be allowed.

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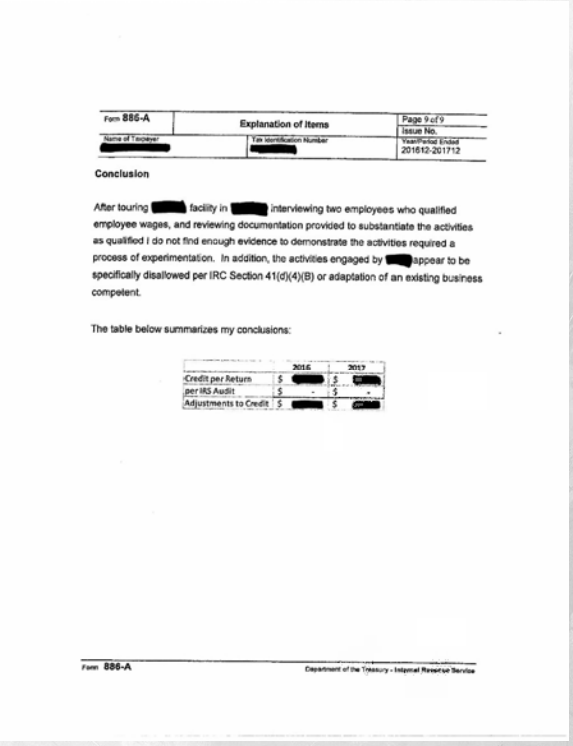

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Name of Taxpayer [redacted]	Tax identification Number [redacted]	Issue No. Year/Period Ended 201612-201712

Conclusion

After touring [redacted] facility in [redacted] interviewing two employees who qualified employee wages, and reviewing documentation provided to substantiate the activities as qualified I do not find enough evidence to demonstrate the activities required a process of experimentation. In addition, the activities engaged by [redacted] appear to be specifically disallowed per IRC Section 41(d)(4)(B) or adaptation of an existing business competent.

The table below summarizes my conclusions:

	2016	2017
Credit per Return	$ [redacted]	$ [redacted]
per IRS Audit	$ -	$ -
Adjustments to Credit	$ [redacted]	$ [redacted]

Form 886-A Department of the Treasury - Internal Revenue Service

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The Appeals Office and the Research Credit

- Ex Parte Rule – Not really
- IRS Engineer is present
- Which projects to discuss – can you limit the scope
- Do I extend the assessment statue or refuse to extend, docket the case in Tax Court and then go to Appeals

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Getting to Appeals

- 30 day letter
- Protest – Skinny or fat – pros and cons
- Do an FOIA request
- Exam's "T-letter"

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Settling the Case at Appeals

- Hazards of litigation
- Does the IRS have uniform settlement guidelines?
- What to do if you hit a "brick wall"?

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Which Court to go to

- U.S. Tax Court
- Federal District Court (refund)
- U.S. Court of Federal Claims (refund)
- Issues to consider
  - Precedent
  - Discovery issues and cost
- IRS v. DOJ

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The Current IRS Litigation Position

- Centralized handling of research credit cases
  - Taxpayer loses the advantage of a full Tax Court calendar
- Settlement options
- Common "hot" items--funded research; contract research; Internal Revenue Code section 6662 penalty; proof of the fixed base percentage, the process of experimentation test is always key

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IRS Attorneys Requests for Information

- IRS attorneys have a set of standard questions
- Need to be able to address these questions in a cost-effective manner
- Trap - the failure to respond can lead to formal discovery or deemed admissions

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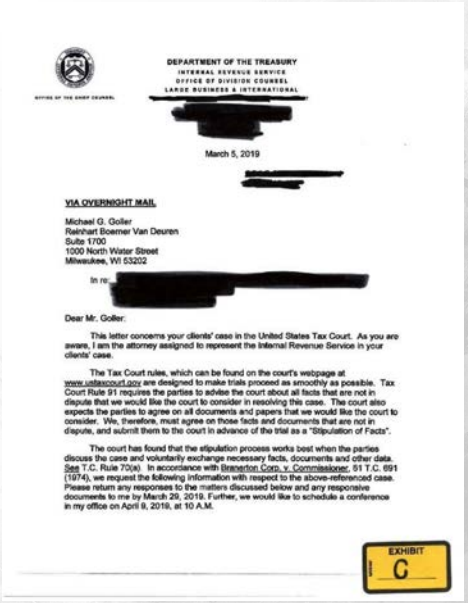
Research Credit Branerton Letter



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
OFFICE OF DIVISION COUNSEL
LARGE BUSINESS & INTERNATIONAL

[redacted]

March 5, 2019

[redacted]

VIA OVERNIGHT MAIL

Michael G. Goller
Reinhart Boerner Van Deuren
Suite 1700
1000 North Water Street
Milwaukee, WI 53202

In re [redacted]

Dear Mr. Goller:

This letter concerns your clients' case in the United States Tax Court. As you are aware, I am the attorney assigned to represent the Internal Revenue Service in your clients' case.

The Tax Court rules, which can be found on the court's webpage at www.ustaxcourt.gov are designed to make trials proceed as smoothly as possible. Tax Court Rule 91 requires the parties to advise the court about all facts that are not in dispute that we would like the court to consider in resolving this case. The court also expects the parties to agree on all documents and papers that we would like the court to consider. We, therefore, must agree on those facts and documents that are not in dispute, and submit them to the court in advance of the trial as a "Stipulation of Facts".

The court has found that the stipulation process works best when the parties discuss the case and voluntarily exchange necessary facts, documents and other data. See T.C. Rule 70(a) In accordance with Branerton Corp. v. Commissioner, 61 T.C. 691 (1974), we request the following information with respect to the above-referenced case. Please return any responses to the matters discussed below and any responsive documents to me by March 29, 2019. Further, we would like to schedule a conference in my office on April 9, 2019, at 10 A.M.

EXHIBIT C

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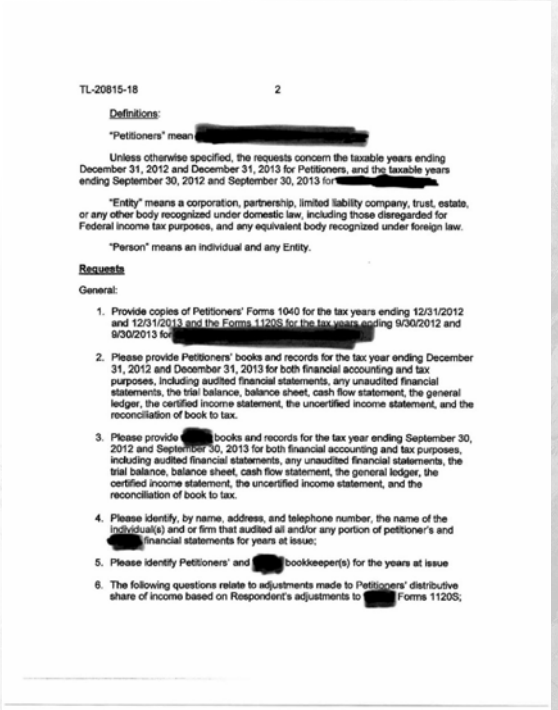

TL-20815-18 2

Definitions:

"Petitioners" mean [redacted]

Unless otherwise specified, the requests concern the taxable years ending December 31, 2012 and December 31, 2013 for Petitioners, and the taxable years ending September 30, 2012 and September 30, 2013 for [redacted]

"Entity" means a corporation, partnership, limited liability company, trust, estate, or any other body recognized under domestic law, including those disregarded for Federal income tax purposes, and any equivalent body recognized under foreign law.

"Person" means an individual and any Entity.

Requests

General:

1. Provide copies of Petitioners' Forms 1040 for the tax years ending 12/31/2012 and 12/31/2013 and the Forms 1120S for the tax years ending 9/30/2012 and 9/30/2013 for [redacted]
2. Please provide Petitioners' books and records for the tax year ending December 31, 2012 and December 31, 2013 for both financial accounting and tax purposes, including audited financial statements, any unaudited financial statements, the trial balance, balance sheet, cash flow statement, the general ledger, the certified income statement, the uncertified income statement, and the reconciliation of book to tax.
3. Please provide [redacted] books and records for the tax year ending September 30, 2012 and September 30, 2013 for both financial accounting and tax purposes, including audited financial statements, any unaudited financial statements, the trial balance, balance sheet, cash flow statement, the general ledger, the certified income statement, the uncertified income statement, and the reconciliation of book to tax.
4. Please identify, by name, address, and telephone number, the name of the individual(s) and or firm that audited all and/or any portion of petitioner's and [redacted] financial statements for years at issue;
5. Please identify Petitioners' and [redacted] bookkeeper(s) for the years at issue
6. The following questions relate to adjustments made to Petitioners' distributive share of income based on Respondent's adjustments to [redacted] Forms 1120S;

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[redacted] 3

a. [redacted]

b. [redacted]

c. [redacted]

d. [redacted]

e. [redacted]

f. [redacted]

g. [redacted]

h. [redacted]

Research Credit:

7. Please separately list each entity in which Petitioners held an interest, that paid or incurred qualified research expenses pursuant to I.R.C. § 41 for the tax years ending December 31, 2012 and December 31, 2013.

8. Please confirm that [redacted] is the only entity whose expenses are included for purposes of the qualified research credit, which Petitioners are claiming qualified research credit.

9. Please identify the individual(s) and/or firm by name, address and telephone number, upon whom Petitioners and/or [redacted] relied when claiming the qualified research credit on its Form 1120s and Form 1040 for the relevant tax years.

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[redacted] 4

10. Provide all documents, including memoranda, from any individual(s) or firm that advised Petitioners and/or [redacted] regarding its claimed qualified research credit for the tax years at issue.

Computation and qualification of research credit:

11. Please provide all documents showing how [redacted] calculated its research credit for the taxable years at issue.

12. If [redacted] undertook sampling to compute any portion of the research credit, please state what sampling technique was used.

13. Please provide a list of projects or activities for which Petitioners claim [redacted] incurred qualified research expenses.

14. For each project or activity identified above in question 13, please list the business component(s) for which Petitioners claim section 41 is applicable.

15. Please confirm that Petitioners are claiming [redacted] only incurred in-house research expenses as qualified research expenses for purposes of calculating the section 41 research credit.

16. For each business component for which Petitioners claim [redacted] incurred qualified research expenses, please provide all documents that support Petitioners' position that [redacted] undertook qualified research during the taxable years at issue.

17. This request pertains to each business component for which Petitioners claim [redacted] incurred qualified research expenses. Please organize your response by business component.

    a. All contracts between [redacted] and the customer, including:

        i. Bid packages;

        ii. Change orders;

        iii. Amendments and modifications;

        iv. Contract drafts;

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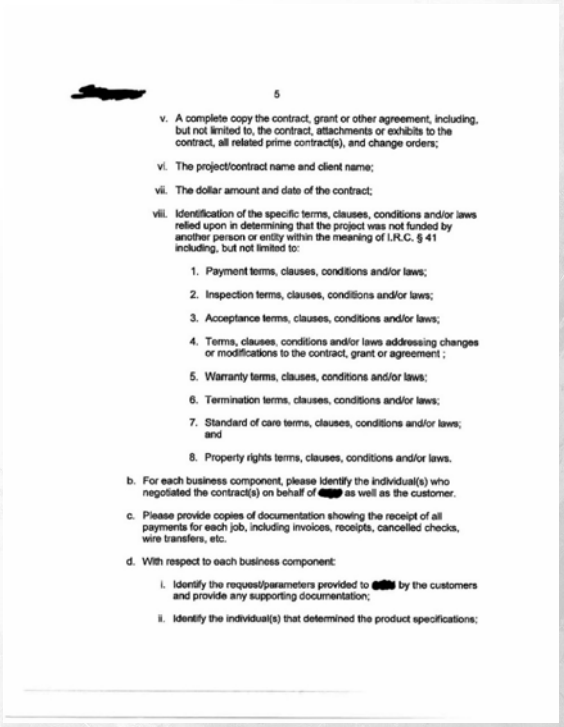

[redacted]

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v. A complete copy the contract, grant or other agreement, including, but not limited to, the contract, attachments or exhibits to the contract, all related prime contract(s), and change orders;

vi. The project/contract name and client name;

vii. The dollar amount and date of the contract;

viii. Identification of the specific terms, clauses, conditions and/or laws relied upon in determining that the project was not funded by another person or entity within the meaning of I.R.C. § 41 including, but not limited to:

1. Payment terms, clauses, conditions and/or laws;
2. Inspection terms, clauses, conditions and/or laws;
3. Acceptance terms, clauses, conditions and/or laws;
4. Terms, clauses, conditions and/or laws addressing changes or modifications to the contract, grant or agreement ;
5. Warranty terms, clauses, conditions and/or laws;
6. Termination terms, clauses, conditions and/or laws;
7. Standard of care terms, clauses, conditions and/or laws; and
8. Property rights terms, clauses, conditions and/or laws.

b. For each business component, please identify the individual(s) who negotiated the contract(s) on behalf of [redacted] as well as the customer.

c. Please provide copies of documentation showing the receipt of all payments for each job, including invoices, receipts, cancelled checks, wire transfers, etc.

d. With respect to each business component:

i. Identify the request/parameters provided to [redacted] by the customers and provide any supporting documentation;

ii. Identify the individual(s) that determined the product specifications;

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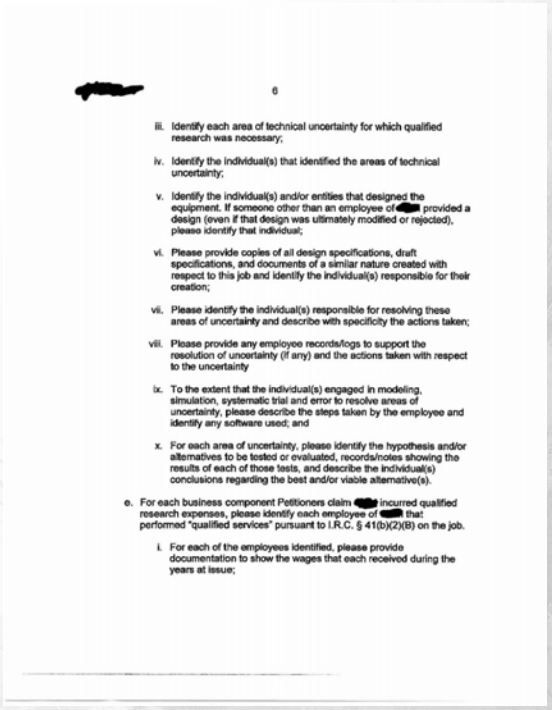

[redacted]

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iii. Identify each area of technical uncertainty for which qualified research was necessary;

iv. Identify the individual(s) that identified the areas of technical uncertainty;

v. Identify the individual(s) and/or entities that designed the equipment. If someone other than an employee of [redacted] provided a design (even if that design was ultimately modified or rejected), please identify that individual;

vi. Please provide copies of all design specifications, draft specifications, and documents of a similar nature created with respect to this job and identify the individual(s) responsible for their creation;

vii. Please identify the individual(s) responsible for resolving these areas of uncertainty and describe with specificity the actions taken;

viii. Please provide any employee records/logs to support the resolution of uncertainty (if any) and the actions taken with respect to the uncertainty

ix. To the extent that the individual(s) engaged in modeling, simulation, systematic trial and error to resolve areas of uncertainty, please describe the steps taken by the employee and identify any software used; and

x. For each area of uncertainty, please identify the hypothesis and/or alternatives to be tested or evaluated, records/notes showing the results of each of those tests, and describe the individual(s) conclusions regarding the best and/or viable alternative(s).

e. For each business component Petitioners claim [redacted] incurred qualified research expenses, please identify each employee of [redacted] that performed "qualified services" pursuant to I.R.C. § 41(b)(2)(B) on the job.

i. For each of the employees identified, please provide documentation to show the wages that each received during the years at issue;

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[redacted] 7

ii. Please explain the compensation agreement for each employee (for example, whether the employee is salaried or received hourly wages);

iii. Please provide the job title and the job description maintained internally for each employee at the time of hiring or, if the employee was promoted after hiring, at the time of the employee's most recent promotion;

iv. Identify how many hours each employee spent working each job during the relevant years, and provide all substantiating documentation (employee logs, records, timecards, etc.);

1. Of those hours spent working each job, please identify how many hours were spent on "qualified services" pursuant to I.R.C. § 41(b)(2)(B);

2. Describe the activities that comprise the "qualified services" pursuant to I.R.C. § 41(b)(2)(B) that were performed by each employee for each job;

v. Identify how many hours each employee spent performing services for [redacted] generally during the relevant tax years;

18. For each business component for which Petitioners claim [redacted] incurred qualified research expenses, please provide all documents supporting the amounts paid or incurred by [redacted] for supplies, if any, used in the conduct of qualified research during the years at issue.

Base Years:

19. Please identify the first taxable year of [redacted] in which the [redacted] had qualified research expenses pursuant to I.R.C. § 41.

20. Please identify the first taxable year in which [redacted] had gross receipts.

21. Please identify all taxable years in which [redacted] had both gross receipts and qualified research expenses pursuant to I.R.C. § 41.

22. Please identify the gross receipts of [redacted] for tax years ending 9/30/08, 9/30/09, 9/30/10 and 9/30/11, and provide documentation to support those figures.

Instructions:

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[redacted] 8

Please see the enclosed Internal Revenue Service Production Specifications for Electronically Stored Information and Hard Copy Documents. Petitioner's responses to our requests should comply with these specifications.

Petitioners should regard these requests as continuing in nature and supplement its responses as required under Tax Court Rule 102.

If any portion of any document is withheld on the grounds of privilege, please state, with respect to each portion withheld:

(a) Name and title of the document;

(b) Individual and institutional author(s);

(c) Date of the document;

(d) Names, titles, and addresses of all recipients of the documents and/or copies thereof;

(e) Subject matter of the document;

(f) Privilege claimed; and

(g) Number of the request(s) to which the production of the document would otherwise be responsive.

If you have any questions, or, if the suggested conference date or time is inconvenient, please write or call me at [redacted]

Sincerely,

[redacted]
Attorney
(Large Business & International)

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Contract and Funded Research (Opposite Sides of the Same Coin)

- In cases of research, where the taxpayer does the research but does not have the risk of loss (i.e., funded research)--does not qualify for the credit. Treas. Reg. § 41(d)(4)(H).
- In cases of contract research where the taxpayer pays for the research, need to be able to show that payment is not contingent on the result. Treas. Reg. § 1.41-2(e)(2).
  - **Have a contract and make it part of the audit record**

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Funded Research

- Watch out for funded research
  - Who is really at risk--amounts paid for the product or the success of the research are not treated as funding research. Treas. Reg. § 1.41-4A(d)(1).
    - **Documentation is often difficult in the context of manufacturing. IRS regulations state all "agreements" between the taxpayer and other persons are to be considered when determining if research is funded. Treas. Reg. § 1.41-4A(d).**
  - Who keeps the right to the research? Treas. Reg. § 1.41-4A(d)(2).

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Funded Research (cont.)

- Purchase Order/Terms and Conditions/Master Purchase Agreement "Trap".
  - Possible Solution
    - A taxpayer retains the right to use the research results without making payments to the payer (the U.S. Government) who obtained the right to use and disclose the technical data from the taxpayers research. Lockheed Martin Corp. v. U.S., 210 F.2d 1338 (Fed. Cir. 2008)

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CASES OF INTEREST

- Populous Holdings v. Comm'r, T.C. Dkt No. 405-17 (2/5/21)
  - Fixed fee contract has an inherent risk of loss
- Meyer, Borgman & Johnson, Inc. v. Comm'r, Dkt No. 7805-16 (unpublished order, 11/19/20, Judge Holmes). A Motion for Reconsideration is pending.
- Little Sandy Coal v. Comm'r, T.C. Memo 2021-5. Appeal pending. Substantially all test (80% of research activity must be a process of experimentation, excludes direct support in the numerator).
- Perficent, Inc. v. Comm'r, DKTs 5467-17, 7600-18 (T.C. 2002). Partial Motion for Summary Judgement is pending: IRS is arguing that contracts were for the purchase of research services (i.e., Funded Research). Taxpayer is arguing that the contracts were for the purchase of products. **IRS is also arguing that warranty provisions in the contracts are not sufficient to the taxpayer has a risk of loss.**

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IRS Likes to Add a Section 6662 In Research Credit Cases

- If there is a low income or a loss year, the math is very pro-IRS

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Penalty Avoidance Matrix

	Reasonable Basis §1.6662-3(b)(3)	Reasonable Cause §6664 §1.6664-4(b)	Disclosure §6662(d)(2)(B) §1.6662-3(a)	Substantial Authority §1.6662-4(d)
Negligence	Yes	Yes	No[1]	Yes[2]
Disregard of the Rules or Regulations	Yes[4]	Yes	Yes[3]	Yes[5]
Substantial Understatement of Income Tax	No	Yes	Yes[6]	Yes
Substantial Valuation Misstatement (Income)	No	Yes[7]	No	No
Substantial Valuation Misstatement (E&G)	No	Yes	No	No
Gross Valuation Misstatement (Income)	No	No[7]	No	No
Gross Valuation Misstatement (E&G)	No	Yes	No	No

1. § 1.6662-7(b).
2. There must also be a reasonable basis for the position, adequate records must be kept and the position must be properly substantiated. §1.6662-3(c). In a case where there is substantial authority for a position, since this standard is higher than the reasonable basis standard (which negates negligence), there is no negligence. §1.6662-3(b)(3).
3. There must be reasonable basis and the taxpayer must keep adequate books, records and substantiation. § 1.6662-3(c)(1).
4. The disregard can be careless, reckless or intentional. § 1.6662-3(b)(2). The first two (careless and reckless) are for all practical purposes, the same as negligence, meaning reasonable basis would negate these two triggers. Further, however, if a position is intentionally contrary to a rule or regulation, reasonable basis would not be enough. However, see the disclosure election.
5. A position that is contrary to a Revenue Ruling or Notice is not treated as disregarding the ruling or notice if the contrary position has a realistic possibility of being sustained (a standard that is lower than substantial authority § 1.6662-3(b)(2). It is technically possible to have substantial authority that is contrary to a Treasury Regulation, which means the penalty could apply. In this case the taxpayer should be sure to make a disclosure.
6.There must also be a reasonable basis for the tax treatment of the disclosed item. §6662(d)(2)(B)(ii).
7.There is no reasonable cause exception for a gross valuation misstatement with respect to charitable deduction property and the exception only applies to a substantial valuation statement when there is a qualified appraisal and the taxpayer made a good faith investigation of the value of the property. § 6664(c)(3).

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What is a Substantial Understatement of Income Tax?

- What is an Understatement of Tax?
  - Excess of the amount required to be shown on the return. Section 6662(d)(2)(A)
- Non-corporate taxpayer
  - Exceeds the greater of 10% of the tax required to be shown on the return or $5,000
- Corporation other than S Corporation or Personal Holding Company
  - Exceeds the lesser of one of the following:
    - 10% of the tax required to be shown on the return (or if greater, $10,000); or
    - $10 Million §6662(d)(1)

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What is a Substantial Understatement of Income Tax (cont.)

- Thus, for a corporation, there in no S.U. penalty if the understatement is under $10,000.
- If 10% of the amount required to be shown on the return excludes $10,000 there is a S.U.
- However, once the understatement exceeds $10,000,000, there is always an S.U., even if $10,000,000 is less than 10% of the amount required to be shown on the return (e.g. amount reported is $102,000,000, amount omitted is 9.9%, $12,870,000). This is not a 10% omission, but there is still a S.U. penalty.

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Research Credit Refund Claims

- Treas. Reg. 301.6402-2(b)(1) – a Claim for Refund "must set forth in detail each ground upon which a … refund is claimed and facts sufficient to apprise the Commissioner of the exact basis thereof."
- Premier Tech v. U.S., 2021-2 U.S. Tax Case (CCH), 2021 WL 2982064 (D. Utah 2021) year 2014, Form 1120X, Taxpayer win

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Research Credit Refund Claims (cont.)

- FAA 20214101F (10/15/21)
  - Huge amount of detail required
  - Transitional Relieve until 2024 (45 days to supplement "incomplete" refund claims)
  - Refund Claims made while under audit are reviewed by the Exam team. Other claims go to the Utah Service Center and subject matter "experts."

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Research Credit Take Aways

- Handling the Audit, Appeals and Litigation
- Funded Research
- Section 6662 Accuracy Related Penalty

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State Credit Issues Example - Wisconsin

- Wisconsin credit for research--looks to the federal credit requirements
- Wisconsin sales and use tax exemption for qualified research. Wis. Stats. § 77.54(57d)(b).

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PART III
Ethics

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Partnership Ethical Concerns

- Conflicts of Interest
  - Who is my client
  - Need a good engagement letter
  - Do I opt-out if I can
  - Do I push out
  - The modification process
  - What does the operating agreement say

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Ethical Obligation to Talk About Penalty Avoidance

- Under IRS Circular 230, practitioners must advise the client of any penalties that are reasonably likely to apply and the practitioner must discuss the possibility of penalty avoidance via disclosure. §10.34(c)

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The Office of Professional Responsibility

- There is often a tendency to assume that the Department of the Treasury's Circular No. 230 (Circular 230) pertains solely to preparing tax returns, tax opinions or dealings with the IRS
- The conventional wisdom is that a violation Of Circular 230 must mean a practitioner has engaged in some sort of outrageous behavior
- The reach of this ethical code is far greater than one might think
- A violation can (and does) occur in many more situations than practitioners might otherwise expect

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A Violation of Circular 230 Is a Serious Matter

- Public discipline for violating Circular 230 usually involves obvious misconduct such as one's own failure to file or pay tax, or the conviction of a criminal offense
- We have been seeing more cases that pertain to alleged "bad tax practice," such as a lack of due diligence, failure to give sound tax advice, conflicts of interest or other issues that indicate a tax practitioner's lack of fitness to practice before the IRS

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Who Is Subject to Circular 230? Section 10.3 (Revised June 9, 2014)

- Circular 230 applies to those who "practice before the IRS"
- "Practice before the IRS" comprehends all matters connected with a practitioner's presentation to the IRS with respect to a taxpayer's rights, privileges or liabilities under the tax law, including
  - Preparing or filing documents, correspondence and communicating with the IRS
  - Rendering written advice with respect to an entity plan or arrangement that has a potential for tax avoidance or evasion
  - Representing a client at IRS conferences and hearings

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Who Is Subject to Circular 230? Section 10.3 (Revised June 9, 2014)

- Attorneys and CPAs (including in-house practitioners) who are not under suspension or disbarment from practice before the IRS may file a Power of Attorney (POA) (Form 2848)
  - This permits them to and practice before the IRS and makes them subject to Circular 230
- One need not file a POA to provide written tax advice, however, providing written tax advice constitutes practice before the IRS
  - *i.e.*, makes the individual subject to Circular 230

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When Is Conduct Sanctionable?

- Generally, a practitioner may be sanctioned if the practitioner:
  - Is incompetent or disreputable;
  - Intentionally misleads a client so as to defraud that client; or
  - Is acting with a specific mental state or competency standard (*i.e.*, willful, reckless or gross incompetence), fails to comply with key provisions of Circular 230

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AICPA Rules

- Statements on Standards for Tax Services

  Statement on Standards for Tax Services No. 1, *Tax Return Positions*

  - Interpretation No. 1-1, Reporting and Disclosures
  - Interpretation No. 1-2, Tax Planning

  Statement on Standards for Tax Services No. 2, *Answers to Questions on Returns*

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AICPA Rules

Statement on Standards for Tax Services No. 3, *Certain Procedural Aspects of Preparing Returns*

Statement on Standards for Tax Services No. 4, *Use of Estimates*

Statement on Standards for Tax Services No. 5, *Departure from a Position Previously Concluded in an Administrative Proceeding or Court Decision*

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AICPA Rules

Statement on Standards for Tax Services No. 6, *Knowledge of Error: Return Preparation and Administrative Proceedings*

Statement on Standards for Tax Services No. 7, *Form and Content of Advice to Taxpayers*

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ABA Model Rules of Professional Conduct

- Some Version of the MRPC has been adopted in almost all states.
- Rules are mandatory.
- Comments to the rules are aspirational (not mandatory).

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Traps for the Tax Practitioner

- Other traps for the unwary practitioner
  - malpractice claims
  - breach of fiduciary duty
  - breach of contract
  - rules of evidence-waiver of the attorney/client privilege
  - disqualification to practice, suspension-disbarment by the State Bar or the Internal Revenue Service
  - reasonableness of fees
  - regulation on advertising
  - invalidation of estate plan
  - violation of rules relating to signing and non-signing tax preparers

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Concerns for the Tax Planner

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Who is My Client?

- Related Issues
  - What is my duty to my client?
  - What are my possible conflicts of interest?
  - Multiple Client Issues
    - Representing spouses
    - Representing a closely-held business
    - Representing fiduciaries (*i.e.*, the trustee or personal representative)

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What Are the Scopes of the Services to Be Performed?

- Importance of a Good Engagement Letter
- Conflict Waivers
- Relationship Between Scope of Services and Diligence and Care Required from the Practitioner

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Is My Client Competent?

- Realities of Modern Life –
- Babyboomers' parents are in their 80s or 90s
- Older babyboomers are in their 70s
- Due to an increase in divorce, more families have step-parents. This can give rise to tension between surviving spouses and stepchildren.
- More people own their own retirement accounts as opposed pensions which are not transferable to the next generation. Thus, a conflict can arise over the disposition of those funds.
- Life expectancies are increasing. Providing adequate health care and concerns over making sure a client has the funds necessary to cover expenses becomes far more difficult to plan for.
- Diseases like Alzheimer's are expected to increase dramatically in the upcoming years
- The interplay between dementia, lack of capacity and susceptibility to undue influence is a potential "perfect storm" for litigation.

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Is My Client Competent? (cont.)

- When does a person have capacity to execute a will or estate planning document?
  - "The testator must have mental capacity to comprehend the nature, the extent and the state of affairs of his property. The central idea is that the testator must have a general, meaningful understanding of the nature, state and the scope of his property, but does not need to have in his mind a detailed itemization of every asset; nor does he need to know the exact value of his property. A perfect memory is not an element of a testamentary capacity. The testator must know and understand his relationship to persons who are or who might naturally or reasonably be expected to become the objects of his bounty for which he must be able to make a rational selection of his beneficiaries. He must understand the scope and general effect of the provisions of his will in relation to his legatees and devisees. Finally, the testator must be able to contemplate these elements together for a sufficient length of time, without prompting, to form a rational judgment in relation to them, the result of which is expressed in the will."

    O'Brien v. Lumphrey, 50 Wis. 2d 143, 183 NW. 2d 133 (1971)
  - Practical comments.

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Role of the Tax Advisor when Dealing with a Client of Potentially Diminished Capacity

- Document that what you are drafting is valid and defensible
- Make sure there are witnesses to the execution of documents
- Confirm that the client consents to disclosure of the contents of the document, however, if there is something unusual it is often a good idea to confirm that item in the presence of the witness (*i.e.*, confirm in front of the witness that a child is being disinherited)

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Role of the Tax Advisor when Dealing with a Client of Potentially Diminished Capacity

- Prepare a contemporaneous memorandum to the client's file
- Consider a video recording or a verbatim transcript in cases where a will contest is expected
- Ask your client about his or her health before executing the testamentary documents. Document this discussion

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Sources of Authority

- ABA Model Rules of Professional Conduct 1.2 scope of representation
- ACTEC Commentary on Model Rule 1.2
- Relationship to Model Rule 1.6 Confidentiality
- Fiduciary Exemption to Rule 1.6, not in existence in every state

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Exculpatory Clauses

- What is an exculpatory clause?
- Model Rule 1.8(h)(i) cannot limit an attorney's liability unless the client is represented when executing the limiting document
- Seeking a release of claims in a proper manner

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Representing Fiduciaries

- ABA Formal Opinion 94-30
- ACTEC Commentary to MRPC 1.2
- Real life examples
  - Residual Beneficiaries versus specific beneficiaries—a trap for the unwary

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Conflicts

- Conflicts of Interest with Current or Former Clients and Obtaining Waivers – Conflict Traps for the Unwary

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Who is My Client?

- Model Rule 1.18, Duties to Prospective Client
  - A person will be considered a prospective client if the person discusses with the lawyer "the possibility of forming a client/lawyer relationship." ABA Model Rule 1.18(a)
  - If the relationship does not come to fruition, the lawyer must still treat the person as a former client for conflict purposes. ABA Model 1.18(b)
  - A problem may arise if the lawyer seeks to represent one party first and then looks to represent another party. A lawyer may not represent an adversary in the same or substantially related matter if "the lawyer receives information from the prospective client that could be significantly harmful to that person in the matter." ABA Model Rule 1.18(c)

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Define Who Will Be The Client

- ABA Model Rule 1.7 (CMT No. [27]) notes that:
  - Conflict questions may arise in estate planning and estate administration. A lawyer may be called upon to prepare wills for several family members, such as husband and wife, and depending on the circumstances, a conflict of interest may be present . . . . In order to comply with conflict of interest rules, the lawyer should make clear the lawyer's relationship between the parties. *Id.*
  - Need a Good Engagement Letter

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Defining the End of the Client Relationship

- Does retention of documents make what would otherwise be a former client, a current client?
  - The ACTEC Commentaries recognize a concept of "dormant representation." The rules provide:
    - The execution of estate planning documents and the completion of related matters, such as changes in beneficiary designations and the transfer of assets to the trustee of a trust, normally ends the period during which the estate planning lawyer actively represents an estate planning client. At that time, unless the representation is terminated by the lawyer or client, the representation becomes dormant, awaiting activation by the client. (See ACTEC Commentary on MRCP 1.7 Conflicts of Interest: Current Clients.)

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Defining the End of the Client Relationship (cont.)

- The ACTEC Commentaries explain as follows:
  - The retention of the client's original estate planning documents does not itself make the client an "active" client or impose any obligation on the lawyer to take steps to remain informed regarding the client's management of property and family status. Similarly, sending a client periodic letters encourages the client to review the sufficiency of the client's estate planning or calling the client's attention to supplemental legal developments does not increase the lawyer's obligations to the client. ACTEC Commentary on MRCP 1.4 (Communication)
- Comment:
  - The ACTEC Commentaries do not seem to go as far as calling the client a former client, but rather "a dormant client." While many commentators would treat such client as a former client, may be, especially, with older estate planning clients, that they will have the expectation that "You were my lawyer," even if they haven't spoken to you for some time.

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Joint Representations

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Circular 230 Conflicts of Interest Section 10.29

- A major cause of malpractice claims, especially for Estate Planners

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A Conflict of Interest Exists If

- The representation of one client will be directly adverse to another client; or,
- There is a significant risk that the representation of one or more clients will be materially limited by the practitioner's responsibilities to another client, a former client or third person, or by the personal interest of the practitioner.

Comment: Rule is very similar to Model Rule 1.7

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Other Authority

- ACTEC Commentary to Model Rule 1.7

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Conflict Waivers – Circular 230 10.29

- The client must provide a written consent waiving the conflict within 30 days of giving verbal consent.
- The written waiver must be retained for at least three years after the conclusion of the representation of any affected client.

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Obtain a Waiver

- Where a conflict exists, a practitioner may still handle the matter if the practitioner reasonably believes that he/she will be able to provide competent and diligent representation to each affected client, the representation will not otherwise violate the law and each affected client waives the conflict in an informed consent at the time the conflict is discovered by the practitioner.

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Traps for the Unwary

- Representing spouses
- Personal interest of the lawyers
  - penalty issues
  - lawyer as a fiduciary
- Lawyer paid by a third party
- Innocent spouse relief issues

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Tax Court Rule 24(g)

- The Rule goes beyond the normal conflict definition and states that if Counsel of Record was involved in planning or promoting a transaction at issue before the Court, that attorney must either obtain a consent or withdraw from the case.
  - This is a trap for the unwary.

Comment: More cases are becoming docketed in Tax Court due to the IRS insistence that a year or more remain on the assessment statute. The estate tax statute on assessment cannot be extended. Thus, the application of Rule 24(g) will come up more often in estate tax cases.

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Why are more and more estate planners finding it necessary to docket a case in Tax Court?

- Two reasons
  - IRS budget cuts
  - Section 6501(c)(4)(A) provides that the statute of limitations on assessment can be extended with regard to "any tax imposed by this title, except *the estate tax* . . ." (emphasis added)
  - Practical Comments

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Additional Trap for the Unwary

- Tax Court Petition is due before an executor is appointed (presumably an income tax issue that pertains to a pre-death year).
- Petition is filed in the name of Joe Smith, Deceased.
- Under Rule 60, must ratify Petition or the case may be dismissed.
- Dismissal of your Tax Court Petition means the IRS assessment stands.

Comment: If the estate has multiple beneficiaries, does the estate and a surviving spouse have a conflict?

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More Conflict Traps for the Unwary

The Practitioner's Own Interest

- A common conflict, which is often overlooked, is the situation where a practitioner prepares a tax return, either as a signing or nonsigning preparer, and then handles the subsequent tax audit or appeal.
- In this situation, there may be a conflict if the practitioner has a personal interest that conflicts with the client's interest.
- For example, if the IRS asserts an accuracy-related penalty, will the practitioner be hesitant to argue that the penalty should not apply because of the taxpayer's good-faith reliance on the practitioner's tax advice?

Comment: The estate and gift tax valuation penalties are mathematical triggers. Thus, if value is too low the trigger (and thus a possible conflict) could arise without much warning.

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More Conflict Traps for the Unwary (cont.)

Representing Both Spouses

- Another common conflict exists when the practitioner represents both a husband and wife, and the two spouses' interests become adverse.
- In such a situation, the practitioner may be unable to represent either spouse.
- Example — clients divorce and there is a pending Tax Court case. Does one spouse have a claim for relief under Section 6015 (i.e., innocent spouse and similar relief)?

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OBTAINING A "GOOD" VALUATION REPORT – The Do's and Don'ts
Obtaining a "Good" Report

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- How to retain an expert
  - Kovel letter
- Does my expert understand the tax law?
  - Section 2703
  - Tax affecting earnings
  - Use of a weighted average when there are multiple valuation methods
- Reliance
- Privilege waiver
- Tax Court Requirements – T.C. Rule 143(g)
- Ethically – What can I tell my experts?

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Switching the Burden of Proof to the IRS

- Burden of proof can be important in valuation cases.
- This is especially so if the IRS does not obtain a good valuation report.
- Thus, failure to shift the burden can be a significant malpractice issue.

Comment: Given IRS budget issues, it is more difficult for the IRS to obtain a solid valuation report.

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Make Sure During the Audit That the Burden of Proof Will Switch at Trial

- Burden to IRS
  - In most civil controversies, a rebuttable presumption existed that the IRS's determination of tax liability is correct
    - *i.e.*, the taxpayer has the burden of proving the IRS is wrong
  - Section 7491 switched the burden to the government in any non-criminal court proceedings, regarding a factual issue, if the taxpayer introduces credible evidence, which is relevant to determination of its liability.

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Make Sure During the Audit That the Burden of Proof Will Switch at Trial (cont.)

- Qualification
  - Code Section 7491, which switches the burden of proof to the IRS, applies only to litigation in the courts between the taxpayer and the IRS;
  - In order to obtain a shift in the burden of proof, the taxpayer must first comply with all requirements of the code section;
  - Comply with substantiation requirements contained in the Code and Regulations;
  - Cooperate fully with the IRS;
  - Exhaust all administrative remedies available to the taxpayer, such as going to the IRS Appeals office; and
  - Produce credible evidence at trial.

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Make Sure During the Audit That the Burden of Proof Will Switch at Trial (cont.)

- The requirement to prove credible evidence means that the burden technically starts out on the taxpayer, but shifts to the government unless the taxpayer produces evidence that would enable the court to find in favor of the taxpayer, absent any contrary evidence being produced by the IRS and ignoring the judicial presumption of IRS correctness.

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Make Sure During the Audit That the Burden of Proof Will Switch at Trial (cont.)

- Finally, the shift in the burden of proof applies to all income, gift, estate, generation-skipping, taxes and all penalties in addition to tax
  - However, it does not apply to corporations, partnerships or trusts with the net worth exceeding $7 million (book value)

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Can a Taxpayer 'Up the Ante' in a Valuation Case

- Can the taxpayer argue that the value was different from the amount reported on the tax return?
- Yes, a taxpayer can, however, the return position is an admission against interest, and the taxpayer is required to produce "cogent proof" that the value on the return is wrong.
- See *Estate of Gallagher v. Commissioner*, T.C. Memo 2011-148

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Ethical Traps that Arise When the IRS Attempts to Collect Tax Due

- Collection issues are not common in the estate and gift tax context
- Lien and Levy
  - Lien - The invisible lien
    - Who is liable for the estate tax
    - Gift tax - the Section 6324(b) lien and secondary donee liability
  - Levy
    - Beware of frivolous collection due process appeals

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Intake

- Is this a good client?
- Consider Conflicts of Interest
- What is scope of the engagement?
- Am I competent? Do I need help?

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Reliance on Others

- Subordinates — care in hiring and delegating
- Experts — care in hiring
  - Is reliance reasonable?
- Protecting client confidentiality — how to retain an expert

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Document Drafting

- Written tax advice
- Delegation to a subordinate
- Due Diligence
- Stay up on changes in the law — draft what the client wants — Listen

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Return Preparation

- Client communication
- Do I disclose?
- Penalty discussions

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Privilege Waiver Issues

- Preparing a tax return
- Valuation experts
  - Is this a good valuation report?
  - Consider penalty thresholds when planning
- Other experts

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Common Tax Planning Traps

- Failure to know who is the client.
- Failure to clarify the scope of services.
- Not asking all the right questions — gather as much information as you can.
- Draft what the client wants.
- Know your limits.
- Ask is the client competent.
    - Remember the due care, due diligence, and competency

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Obligations of the CPA Firm If There Is a Data Breach

- CPA Firms Need to Collect Data

<u>Tax</u>

- Statement on Standards for Tax Services ("SSTS") No. 3, Certain Procedural Aspects of Preparing Returns
    - "Even though there is no requirement to examine underlying documentation, a member [CPA] should encourage the taxpayer to provide supporting data where appropriate"

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Obligations of the CPA Firm If There Is a Data Breach (cont.)

- New AICPA Rule
  - Code of Professional Conduct Rule 1.700.001, and Interpretation 1.700.005 provide that "a member would be considered in violation of the Confidential Client Information Rule [1.700.001] if the member cannot demonstrate that safeguards were applied that limited or reduced significant threats to an acceptable level"

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How Could This Happen to Me?

- The theft of an unencrypted laptop
- The loss of an unencrypted thumb drive
- Theft by a disgruntled employee
- E-mail to the wrong e-mail address
- Data breach at a cloud-based provider
- Hacker attack on a firm
- Failure to shred old client records

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Obligations of the CPA Firm If There Is a Data Breach (cont.)

- State Laws — most states have laws and regulations which require notification in the case of a data breach
- If you possess client medical data, HIPAA becomes relevant
- Notify clients

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Failure to Obtain PTIN Section 10.8(a)

- Any individual who, for compensation, prepares or assists in the preparation of all or substantially all of a tax return or claim for refund must have a PTIN
- Generally, one must be a licensed attorney, certified public accountant, enrolled agent or registered return preparer to obtain a PTIN

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Need both a PTIN and a Data Security Plan

IRS

Return Preparer Office — September 24, 2019

Resources:

IRS.gov
Frequently Asked Questions
Annual Filing Season Program
Enrolled Agent Information
Pay.gov System
Online PTIN System

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Dear Tax Professional,

Summer is over, and it won't be long until you're sitting down at your computer to renew your preparer tax identification number (PTIN) for 2020. In mid-October when renewal season begins, you will notice a *data security responsibilities* statement has been added to the PTIN renewal process. It serves as a reminder of your legal responsibility to have a data security plan and to provide data and system security protections for all taxpayer information. When completing your PTIN renewal, a checkbox will be available to confirm your awareness of these data security responsibilities.

Data security continues to be a hot topic. That's because tax professionals remain a top target of identity thieves and data breaches continue to affect tax professionals at an alarming rate. Cybercriminals use sophisticated and ever evolving techniques to gain access to your systems. These criminals steal sensitive taxpayer data to file fraudulent tax returns and create financial havoc for your clients. There are simple steps you can incorporate in your daily operations to minimize your vulnerability and protect client data, including:

- Protect email accounts with strong passwords and two-factor authentication if available.
- Install an anti-phishing tool bar to help identify known phishing sites.
- Use anti-phishing tools that are included in security software products.
- Use security software to help protect systems from malware and scan emails for viruses.
- Never open or download attachments from unknown senders, including potential clients. They should instead make contact first by phone.
- Send only password-protected and encrypted documents when files must be shared with clients over email.
- Never respond to suspicious or unknown emails.
- Back up sensitive data to a safe and secure external source.
- Properly dispose of old computer hard drives that contain sensitive data.

You should also make sure to have a written data security plan in accordance with the Federal Trade Commission's Safeguard Rule. Remember, protecting your clients is not only good for business, it's also the law. While the hope is that you're never the victim of a data breach, preparation and education will go a long way in helping to protect your clients and yourself.

More information:
Publication 4557, Safeguarding Taxpayer Data

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Publication 5293, Data Security Resource Guide for Tax Professionals
Identity Theft Information for Tax Professionals

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Firm Management Procedures to Ensure Circular 230 Compliance Section 10.36 (Revised June 10, 2014)

- The IRS appears to be attempting to create a "culture of compliance"
- Practitioners in a position of authority must do more than ensure their own compliance with Circular 230
- Supervising practitioners must ensure that all individuals they supervise comply with Circular 230 as it pertains to the preparation of returns, claims for refund or other documents submitted to the IRS

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Section 10.36

- A practitioner responsible for implementation of Circular 230 compliance procedures will be subject to disciplinary action if:
  - 1(a) The responsible practitioner, through willfulness, recklessness or gross incompetence, does not take reasonable steps to ensure that the firm has adequate procedures to comply with Circular 230; and
  - 1(b) One or more individuals who are members of, associated with, or employed by the firm are, or have engaged in a practice in connection with their practice with the firm of failing to comply with Circular 230;

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Section 10.36

2(a) The responsible practitioner, through willfulness, recklessness or gross incompetence, does not take reasonable steps to ensure that firm procedures in effect are properly followed; and

2(b) One or more individuals who are members of, associate with, or are employed by the firm or have engaged in a pattern or practice, in connection with their practice with the firm of failing to comply with Circular 230; or

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Section 10.36

3(a) The responsible practitioner knows or should know that one or more individuals who are a member of, associated with, or employed by the firm are, or have engaged in a pattern or practice in connection with their practice with the firm that does not comply with Circular 230, as applicable; and

3(b) The responsible practitioner, through willfulness, recklessness or gross incompetence, fails to take prompt action to correct the noncompliance.

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Written Tax Advice Form Section 10.35 and Section 10.37(a) Revised June 9, 2012

- The Covered Opinion Rules (Former §10.35)
  - These have gone away — Proposed regulations were issued on September 14, 2012
  - Final regulations were issued June 9, 2014 and became effective on June 12, 2014

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Old Rules

- Certain burdensome requirements existed if one issued one of the following:
  - A listed transaction opinion;
  - Principal purpose opinion is tax avoidance; or
  - Significant purpose to avoid tax opinion PLUS the opinion is one of the following opinions
    - Reliance Opinion
    - Marketed Opinion
    - Opinion subject to conditions of confidentiality
    - Opinion subject to contractual protection

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Ramifications of the Withdrawal of the Covered Opinion Rules

- No more legends on our e-mails
- Issuing a tax opinion may be more complex than before
- It is clear under the new rules that government submissions on matters of general policy and continuing education presentations are not considered written tax advice

Requirements for Written Tax Advice Section 10.37(a) (Revised June 9, 2014)

- The Practitioner must
  - Base written advice on reasonable factual and legal assumption
    - Including assumptions as to future events
  - Reasonably consider all relevant facts and circumstances the practitioner knows or reasonably should know
  - Use reasonable efforts to identify and ascertain the facts relevant to written advice on each federal tax matter

Requirements for Written Tax Advice Section 10.37(a) (Revised June 9, 2014)

- Not rely upon representations, statements, findings or agreements (including projections, financial forecasts, or appraisals) of the taxpayer or any other person if reliance upon them would be unreasonable
- Relate applicable law and authorities to the facts; and not, in evaluating a federal tax matter, take into account the possibility that a tax return will not be audited or that a matter will not be raised on audit

Further, reliance upon a representation, statement, finding or agreement is specifically unreasonable if the practitioner knows or reasonably should know that one or more representations or assumptions on which any representation is based is incorrect, incomplete or inconsistent

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Reliance on Others Section 10.37(b) Revised June 9, 2014

- The practitioner may only rely on the advice of another person if the advice was reasonable and the reliance is in good faith considering all the facts and circumstances
- Reliance is specifically not reasonable when
  - The practitioner knows or reasonably should know that the opinion of the other person should not be relied upon;
  - The practitioner knows or reasonably should know that the other person is not competent or lacks the necessary qualifications to provide the advice; or
  - The practitioner knows or reasonably should know that the other person has a conflict of interest in violation with Circular 230
    - *e.g.*, the conflict has not been properly waived

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Standard of Review
Have I Complied with the Rule?

- In evaluating whether a practitioner's written tax advice complies with Section 10.37, the IRS will apply a "reasonable practitioner" standard, considering all facts and circumstances, including, but not limited to the scope of the engagement and the type and specificity of the advice sought by the client

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Standard of Review
Have I Complied with the Rule?

- In the case of an opinion the practitioner knows or has reason to know will be used or referred to by a person other than the practitioner in promoting, marketing or recommending a transaction, a significant purpose of which is the avoidance or evasion of tax, the IRS will apply an elevated "reasonable practitioner" standard. Emphasis will be given to the additional risk, caused by the practitioner's lack of knowledge of the specific taxpayer's particular circumstances (***i.e.*, when tax advice is going to be used to promote a transaction to a third party, the IRS will apply an elevated standard of care**).

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Due Diligence
Section 10.22 (Revised June 9, 2014)

- Practitioner Must Exercise Due Diligence
  - Every practitioner must exercise due diligence when practicing before the IRS
    - This includes exercising diligence in preparing documents relating to IRS matters and verifying the correctness of oral and written presentations made to both the IRS and one's client with regard to any matter administered by the IRS
    - A practitioner's duty to be diligent is a very broad concept
    - A lack of diligence would seem to exist in most instances of deficient practice-related conduct

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Due Diligence
Section 10.22 (Revised June 9, 2014)

- The concept of diligence seems to require more than the mere belief that a presentation is correct the moment it is submitted to the IRS or a client
  - The implied approval of past incorrect statements would seem to be a violation of Section 10.22
  - If a practitioner fails to correct an incorrect statement made to the IRS or a client, knowing full well that the recipient continues to rely on that statement
  - A failure to correct the error is inconsistent with the practitioner's obligation to be diligent

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Reliance on Others

A practitioner will be presumed to have exercised due care if the practitioner relies on the work product of another person so long as the practitioner used reasonable care in engaging, supervising, training, and evaluating the person, taking into account the nature of the relationship between the practitioner and the other person

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Diligence as to Accuracy §10.22

- Trap for the unwary — FBAR (FinCin 114) and foreign bank accounts

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Use of Estimates

- AICPA Statement on Standards for Tax Services No. 4, Use of Estimates
  - Unless prohibited by statute or by some other rule, a CPA may use the taxpayer's estimates in the preparation of a tax return if it is not practical to obtain exact data and if the CPA determines that the estimates are reasonable based on the facts and circumstances known to the CPA
    - The taxpayer's estimate should be presented in a manner that does not imply greater accuracy than exists

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Am I Bound by the Prior Audit or Court Case?

- AICPA Statement on Standards for Tax Services No. 5, Departure from a Position Previously Concluded in an Administrative Proceeding or Court Decision
  - A conclusion in an audit or court proceeding does not restrict a CPA from recommending a different position in a later year unless a taxpayer is bound to a specified treatment by a formal closing agreement or some other method
    - However, the CPA must still satisfy the normal standards for preparing a tax return. See SSTS No. 1, Tax Return Positions.

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Am I Bound by the Audit or Prior Court Case?

- Thus generally, the result of the audit or court case will indicate how to treat the item in a later year
  - There could be exceptions, for example
    - If the prior decision was due to nothing more than a lack of documentation;
    - If the taxpayer yielded in an administrative proceeding for settlement purposes, but has a legitimate basis for not adopting the position; or,
    - New court decisions, rulings or other authorities have been promulgated since the prior proceeding.

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Preparer Penalty Standards Under I.R.C. Section 6694(a)

Standard	Preparer Duty
Frivolous[1]	Cannot prepare tax return
Reasonable basis[2]	Can prepare tax return with disclosure[3]
Substantial authority[4]	Need not disclose unless a tax shelter or a Section 6662A Reportable Transaction[5]
Reasonably believe more likely than not (i.e., more than 50%)	Need not disclose

[1] The percentage of comfort is perhaps 5% or less
[2] Reasonable basis is defined in Section 1.6662-3(b)(3); the percentage of comfort is perhaps 20%
[3] Use Form 8275 or 8275R, or disclose pursuant to annual revenue procedure (e.g., Rev. Proc. 2015-16)
[4] "Substantial authority" is defined in Section 1.6662-4(d). It is a comfort level of perhaps 40% or more
[5] A tax shelter is an arrangement that has a significant purpose of avoidance or evasion of income tax. Section 6662(d)(2)(C)(iii). See Notice 2009-5 for how, in limited situations, to lower the standard to substantial authority for a tax shelter (basically educate the taxpayer about penalty exposure and document this fact)

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Competence — Section 10.35 (Revised June 9, 2014)

- A practitioner must possess the necessary competence to engage in practice before the IRS
- Competent practice requires knowledge, skill, thoroughness and the preparation necessary for the matter at issue
- A practitioner may become competent through various methods such as consulting with experts or studying the relevant law

Comment: Sections 10.35 and 10.36 together mean that managers have a duty to ensure that their subordinates have the requisite knowledge and skill and that they appropriately use that knowledge and skill

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AICPA Rules

- AICPA Code of Professional Conduct, Section 50, Article V, Due Care
- "... Members should be diligent in discharging responsibilities to clients, employers and the public. Diligence imposes the responsibility to render services promptly and carefully, to be thorough, and to observe applicable technical and ethical standards ..."

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MRPC -1.3

- A lawyer shall act with reasonable diligence and promptness in representing a client

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Prompt Disposition of Matters and Responses to Requests for Information §10.20 and §10.23

- If the IRS makes a proper request for records or information, a practitioner must promptly respond to the request unless the practitioner reasonably has the good-faith belief that the information is privileged
- A practitioner may not unreasonably delay the prompt disposition of any matter before the IRS

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Prompt Disposition of Matters and Responses to Requests for Information §10.20 and §10.23

- The practitioner must make a reasonable inquiry of the practitioner's client as to who has possession or control of the requested information
  - However, a practitioner need not make inquiry of any other persons or verify information provided by the client

Comment: Consider these rules when responding to a "wealth squad" IDR, a detailed LB&I IDR or a very broad discovery request.

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Prompt Disposition of Matters and Responses to Requests for Information §§10.20 and 10.23

- Where the documents or information requested by the IRS are not in the possession of the practitioner or client, the practitioner must promptly provide the IRS employee seeking the information with any information the practitioner has about who has possession or control of the requested information

Comment: This rule certainly seems to raise Section 7525 and attorney-client concerns

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What Are the Scopes of the Services to Be Performed?

- Importance of a Good Engagement Letter
- Conflict Waivers
- Relationship Between Scope of Services and Diligence and Care Required from the Practitioner

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Privilege Waiver Issues

- Preparing a tax return
- Valuation experts
  - Is this a good valuation report?
  - Consider penalty thresholds when planning
- Other experts

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Privileges In a Tax Setting

- Federal Rules of Evidence – Rule 501- Privileges in General
  - Rule 501 provides that common law governs a claim of privilege unless provided otherwise by the Constitution, a federal statute, or rules prescribed by the Supreme Court. In a civil case, state law governs.
- There are a Number of Relevant Privileges
  - Attorney-Client
  - Accountant-client or practitioner privilege
  - Work Product Doctrine
    - Each can be waived
    - There are exceptions to each Recent case law
  - Spousal Privilege

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Attorney-Client Privilege (cont.)

The Kovel Letter

- The Privilege Can Extend Communications with the Attorney's Agents
- So long as a client's communication is made to an agent of an attorney (*i.e.*, a CPA that has been retained by the attorney) in confidence, for the purpose of obtaining Legal Advice from the lawyer, it is privileged. *United States v. Schwimmer*, 892 F.2d 237, 243 (2d Cir. 1989).
- What is a *Kovel* Letter?
- This rule, generally known as the *Kovel* rule. The application of the *Kovel* rule can be difficult in situations where non-legal services, such as preparing a tax return, are provided with legal services because it is difficult to distinguish between communications made for the preparation of a tax return and those made for the provision of legal services. Because the *Kovel* rule rests on the attorney-client privilege, the protection of the *Kovel* rule is lost anytime the attorney-client privilege is lost.
- When to use a *Kovel* Letter.

Comment: The key is the facilitation of communication between the lawyer and client

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PART IV
High Net Worth And Family Off Issues

- FY 2022 Audit Campaign Issue
- High-income taxpayers will continue to receive audit attention (the audit rate is approximately 9% for those reporting income of $1 Million to $5 Million)
  - These taxpayers often have income and losses from flow-through entities
  - Thus, the audit of an individual will often lead to the examination of various related entities

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High Net Worth Issues (cont.)

- The audit process involves a review of not only the taxpayer's personal income tax return, but also related partnership tax returns, fiduciary income tax returns, and estate and gift tax returns
- The audit is a complete review of the taxpayer(s) (*i.e.*, the IRS uses LB&I Audit Methods and Techniques)

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High Net Worth Issues (cont.)

- Responding to Information Document Requests can be very burdensome, with a number of practical and ethical concerns
- IRS Counsel is often involved through the audit
- Often if information is not produced by the IDR deadline the IRS will issue a pre-summons letter and then an IRS summons

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High Net Worth Issues (cont.)

Some examples of the broad scope of high net worth audits include

- Estate and Gift tax issues
- **Valuation issues**
- Executive Compensation
- C corporation and S corporation issues
- Noncash charitable contributions
- **Partnership and LLC issues**
- Passive activity losses
- Foreign Trusts
- Foreign Bank Account reporting
- Basis and At-Risk issues
- Transfer Pricing Issues
- **Private airplane issues**

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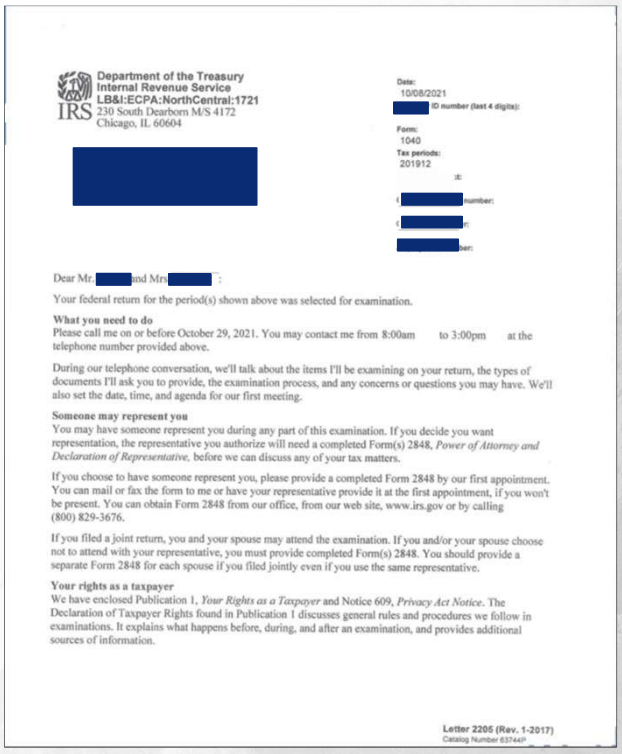

Department of the Treasury
Internal Revenue Service
LB&I:ECPA:NorthCentral:1721
230 South Dearborn M/S 4172
Chicago, IL 60604

[redacted]

Date:
10/08/2021
[redacted] ID number (last 4 digits):
Form:
1040
Tax periods:
201912
[redacted] number:
[redacted]
[redacted]ber:

Dear Mr. [redacted] and Mrs [redacted]

Your federal return for the period(s) shown above was selected for examination.

What you need to do
Please call me on or before October 29, 2021. You may contact me from 8:00am to 3:00pm at the telephone number provided above.

During our telephone conversation, we'll talk about the items I'll be examining on your return, the types of documents I'll ask you to provide, the examination process, and any concerns or questions you may have. We'll also set the date, time, and agenda for our first meeting.

Someone may represent you
You may have someone represent you during any part of this examination. If you decide you want representation, the representative you authorize will need a completed Form(s) 2848, *Power of Attorney and Declaration of Representative*, before we can discuss any of your tax matters.

If you choose to have someone represent you, please provide a completed Form 2848 by our first appointment. You can mail or fax the form to me or have your representative provide it at the first appointment, if you won't be present. You can obtain Form 2848 from our office, from our web site, www.irs.gov or by calling (800) 829-3676.

If you filed a joint return, you and your spouse may attend the examination. If you and/or your spouse choose not to attend with your representative, you must provide completed Form(s) 2848. You should provide a separate Form 2848 for each spouse if you filed jointly even if you use the same representative.

Your rights as a taxpayer
We have enclosed Publication 1, *Your Rights as a Taxpayer* and Notice 609, *Privacy Act Notice*. The Declaration of Taxpayer Rights found in Publication 1 discusses general rules and procedures we follow in examinations. It explains what happens before, during, and after an examination, and provides additional sources of information.

Letter 2205 (Rev. 1-2017)
Catalog Number 63744P

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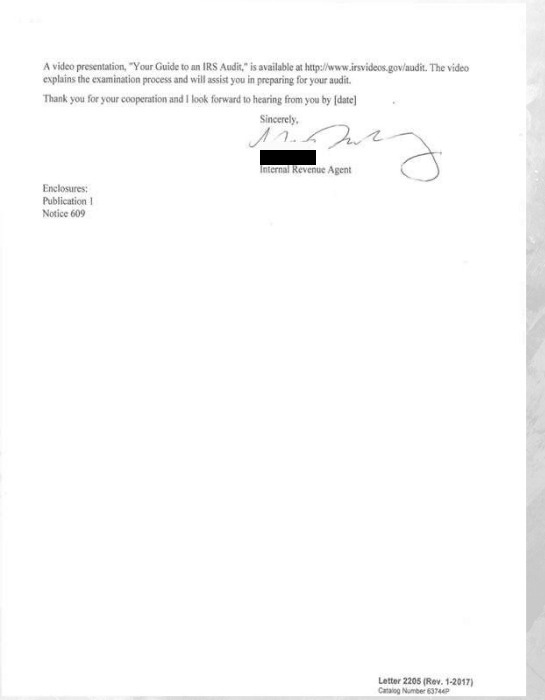

A video presentation, "Your Guide to an IRS Audit," is available at http://www.irsvideos.gov/audit. The video explains the examination process and will assist you in preparing for your audit.

Thank you for your cooperation and I look forward to hearing from you by [date]

Sincerely,

[redacted]
Internal Revenue Agent

Enclosures:
Publication 1
Notice 609

Letter 2205 (Rev. 1-2017)
Catalog Number 63744P

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Form 4564	Department of the Treasury Internal Revenue Service Information Document Request	Request Number 001
To: and	Subject: Initial IDR - Form 1040 – 201912	
	Submitted to:	
	Dates of Previous Requests: N/A	

Description of Documents Requested:

The purpose of this Information Document Request (IDR) is to obtain information relevant to your Form 1040 filed for the tax year ending December 31, 2019.

Please provide the following documentation:

1. Copies of any amended Forms 1040 (including all schedules/attachments) filed for the tax year ending December 31, 2018, December 31, 2019, and December 31, 2020.
2. Copies of any correspondence from the Internal Revenue Service concerning Form 1040 for the tax year ending December 31, 2019 excluding the Letter 2205 (initial contact letter) sent by .
3. Copies of all audit reports issued by any federal or state agency for tax year ending December 31, 2019.
4. Personal net wealth and/or financial statement(s) as of December 31, 2019, if available. This should include the method of accounting used to compile them, net worth computations or other financial data regarding your assets, liabilities, net worth, income and losses, and cash flows from all sources within and without the United States, including all underlying documents and any applicable exhibits and/or footnotes associated therewith, and if not apparent, please identify the preparer of such documents. If not available, provide a negative written response.
5. A brief summary of your business and investment activities, including items reported on the Form 1040, Schedule E. For activities identified as non-passive, elaborate on your involvement and day-to-day role with each entity.
6. Provide a copy of the worldwide legal organization chart as of January 1, 2019 and December 31, 2019 including all domestic and foreign affiliates, places and dates of incorporation and their relationship to the reporting partnership/LLC for the entities you have greater than 50% control of through the rules of attribution. This chart should include all entities to which the Taxpayer is related within the meaning of Section 267.

Information Due By 11/05/21 At Next Appointment ☐ Mail In ☐

	Name and Title of Requestor: Internal Revenue Agent	Badge Number: Phone: Fax: Email:	Date: 10/8/2021
FROM	Office Location: Internal Revenue Service; Mail Stop 4171 LB&I:ECPA:1113; 230 S. Dearborn; Chicago, IL 60604		Page 1 of 3

Form 4564

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Form 4564	Department of the Treasury Internal Revenue Service Information Document Request	Request Number 001
To: [redacted] and [redacted] [redacted]	Subject: Initial IDR - Form 1040 – 201912	
	Submitted to:	
	Dates of Previous Requests: N/A	

Description of Documents Requested:

The following should be included in the chart:
a. Name of each entity,
b. Employer Identification Number,
c. Ownership percentage in each entity,
d. U.S. tax treatment of entity,
e. Country in which the entity was created or organized,
f. Country in which the entity operates, and
g. Business activity of the entity.

If there is a difference in entities reported at January 1, 2019 and December 31, 2019, please provide an explanation.

7. Tax return workpapers and reconciliation schedules used to prepare the Form 1040 (original and amended, if applicable) for the tax year ending December 31, 2019.
8. For all disregarded entities with activities reported on the Taxpayer's (each spouse) individual tax returns for the tax year ending December 31, 2019, please provide:
   a. Detail General Ledger Transaction file (Lowest level transaction detail that can be reconciled to the Year-end Trial Balance amounts),
   b. Year-end Trial Balance file showing beginning of the tax period balances and end of the tax period balances,
   c. Chart of Accounts (GL Account Number, GL Account Name, Account Type),
   d. LLC Operating Agreements,
   e. Check-the-box elections (Form 8832), and
   f. Reconciliation of the Profit and Loss records to the Form 1040 tax return.
9. Provide all Schedule K-1s issued to , , and its disregarded entity/entities (flowing into Form 1040) for tax year ending December 31, 2019. Provide any Schedule K-1 workpapers and reconciliation to the 2019 tax return.

Information Due By 11/05/21 At Next Appointment ☐ [illegible] ☐

	[illegible] of Requestor: Internal Revenue Agent	Badge [illegible] Phone: Fax: Email:	Date: 10/8/2021
FROM	Office Location: Internal Revenue Service; Mail Stop 4171 LB&I:ECPA:1113; 230 S. Dearborn; Chicago, IL 60604		Page 2 of 3

Form 4564

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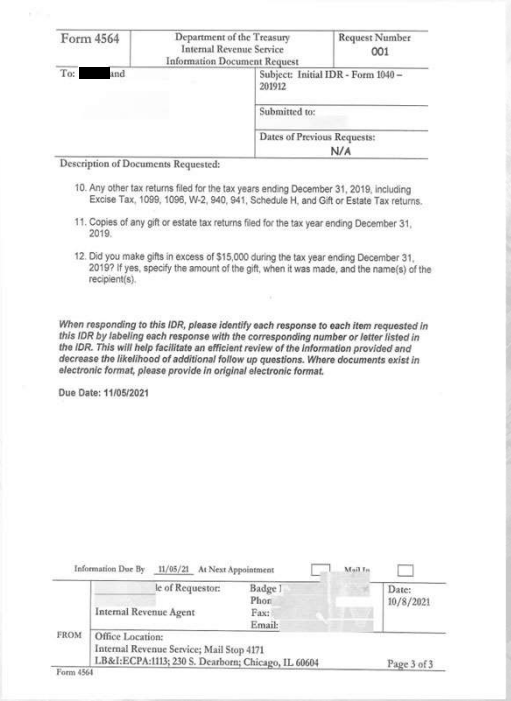

Form 4564 | Department of the Treasury, Internal Revenue Service, Information Document Request | Request Number 001

To: [redacted]and

Subject: Initial IDR - Form 1040 – 201912

Submitted to:

Dates of Previous Requests: N/A

Description of Documents Requested:

10. Any other tax returns filed for the tax years ending December 31, 2019, including Excise Tax, 1099, 1096, W-2, 940, 941, Schedule H, and Gift or Estate Tax returns.

11. Copies of any gift or estate tax returns filed for the tax year ending December 31, 2019.

12. Did you make gifts in excess of $15,000 during the tax year ending December 31, 2019? If yes, specify the amount of the gift, when it was made, and the name(s) of the recipient(s).

When responding to this IDR, please identify each response to each item requested in this IDR by labeling each response with the corresponding number or letter listed in the IDR. This will help facilitate an efficient review of the information provided and decrease the likelihood of additional follow up questions. Where documents exist in electronic format, please provide in original electronic format.

Due Date: 11/05/2021

Information Due By 11/05/21 At Next Appointment ☐ Mail To ☐

[redacted]le of Requestor: Badge [redacted]
Phon[redacted]
Internal Revenue Agent Fax: [redacted]
Email: [redacted]
Date: 10/8/2021

FROM Office Location:
Internal Revenue Service; Mail Stop 4171
LB&I:ECPA:1113; 230 S. Dearborn; Chicago, IL 60604

Form 4564 Page 3 of 3

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Lender Mgmt LLC V. Comm'r, T.C. Memo 2017-25

- Family office takes a profits interests in investments and is treated as a trade or business.

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PART IV

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Employment Tax Issues

- New Audit Program
- Three Main Issues -
  - Employee/Independent Contractor
  - Fringe benefit issues
  - Deduction issues

October 1, 2021 – A very interesting day

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Fringe Benefit Issues

- Executive compensation issues in general
- Vehicle and tool *per diem* issues
- IRS is looking at the issue of whether employees are attempting to turn "wages" into taxable *per diem* allowances
  - Carefully scrutinize what expenses can be included in a *per diem*
- Comment: Contractors who have a large amount of unreimbursed business expenses are asking for increased per diems due to the nondeductability of these expenses.

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Section 530 of the Revenue Act of 1978

- Generally allows taxpayer to treat worker as not being an employee for employment tax, but not income tax or other purposes
- Must have reasonable basis and meet certain requirements

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Section 530 of the Revenue Act of 1978 (cont.)

- *Reasonable basis* for treating a worker as an independent contractor exists if the taxpayer reasonably relied on

1. Past IRS audit practice with respect to the taxpayer, or
2. Published rulings or judicial precedent, or
3. Long-standing recognized practice in the industry of which the taxpayer is a member, or
4. If the taxpayer has any "other reasonable basis" for treating a worker as an independent contractor.

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Section 530 of the Revenue Act of 1978 (cont.)

Comment: When section 530 relief is at issue, the IRS is supposed to consider the application of this relief before determining if an employment relationship existed.

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Section 530 of the Revenue Act of 1978 (cont.)

- Additional requirements
  1. The taxpayer must not have treated the worker as an employee for any period
  2. All federal tax returns, including information returns, must have been filed on a basis consistent with treating such worker as an independent contractor
  3. The taxpayer (or a predecessor) must treat all workers holding substantially similar positions consistently for purposes of employment taxes
     - The "similar worker consistency requirement"

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Statute of Limitations in Employment Tax Cases

Section 6513 governs when a return is deemed to be filed for purposes of Section 6511 (i.e., for purposes of whether a claim for refund is timely filed). Subsection (c) pertains to Social Security Taxes and Income Tax Withholding (i.e., the taxes reported on a Form 941). Section 6513(c) provides that:

> If a **return** for any period ending with or within a calendar year **is filed before April 15** of the succeeding calendar year, such return shall be considered filed on April 15 of such succeeding calendar year.
> § 6513(c)(1). (Emphasis added.)

Thus, when a Form 941 for a period is filed before April 15 of the following period, the tax return is considered filed on April 15 of that following year.

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Interest-Free Adjustments

- Generally, for employment tax (i.e., Form 941 obligations), if the adjustment to the Form 941 (i.e., the tax deficiency) is
  - paid on or before the due date of the 941 for the period in which the error is "ascertained,"
  - the amount of the underpayment shall be paid without interest being charged.
- An error is ascertained when resolved at examination or with appeals.

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Interest-Free Adjustments (cont.)

- If, however, the case is not resolved at Appeals and the taxpayer receives a notice and demand for payment from the IRS, the adjustment will not be interest free.
- In addition, the taxpayer will not be allowed an interest free adjustment where a prior audit found that additional tax was due with respect to the same issue.

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Valuation Issues

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Traps for the Unwary When Obtaining Valuation/ Appraisal Reports

- *Exelon v. Comm'r*, 906 F.3d 513 (7th Cir. 2018)
  - SILO tax shelter
  - Appraisal of power plant found to lack credibility because the attorney interfered with the integrity and independence of the appraiser by providing wording and conclusions the lawyer expected to see so that the lawyer could issue a tax opinion
  - Loss on (1) valuation issue; and (2) reasonable cause defense to a penalty
- Need an appraiser who understands the process
- Be careful about "educating" an appraiser
- Assume whatever is sent to the expert will be made available to the IRS

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Valuation Checklist

- The Cover Letter – Summary
  - Who is the retaining party and other intended users?
  - Use the Correct Definition of Fair Market Value ("FMV"), FMV for a gift, Treas. Reg. Section 25.2512-1 defines fair market value as
    - **[T]he price at which property would change hands between a willing buyer and a willing seller, Neither being under any compulsion to buy or sell and both having reasonable knowledge of the Relevant facts**

Valuation Checklist (cont.)

- **The "as of" or date**
- **Purpose of the valuation and intended use (e.g. estate and gift tax purposes)**
- Type of asset and interest being valued (i.e. a minority interest . . .)
- Control Rights - in any
- Access to Liquidity
- The Scope of Work
- Information Considered
- Methodologies Utilized
- Fair Market Value Conclusion

Valuation Checklist (cont.)

- The Report- Body
  - Standard of value – Define FMV again
  - Purpose of the valuation
  - What is being valued?
  - Prior transactions if any
  - What interest is being valued
  - Economic overview / market conditions
  - Company specific information
  - Methodologies used to determine FMV (Holding Company v. Active Business).

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Valuation Checklist (cont.)

- Discounts. Do not rely only on case law. Berg Estate v. Comm'r, T.C. Memo 1991-279
- Explain the weight given to each methodology used. Otherwise if one methodology is rejected, the whole report any fail. True Estate v. Comm'r T.C.Memo 2001-167 aff'd., 390 F.3d 1210 (10th Cir 2004)
- Tax Affecting Earnings if an S Corp. or Partnership. Calculation both ways. Recent Cases, Kress, Estate of Jones. If do not tax affect, can the marketability discount be increased.

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Reliance and Reasonable Cause

- Ordinary business care and prudence
- Three part test when relying on a professional advisor.
  1. The advisor was competent and had sufficient expertise;
  2. The taxpayer provided the necessary and adequate information to the advisor; and
  3. The taxpayer relied in good faith on the advisor.

Neonatology Assocs., P. A. v. Comm'r, 115 T.C. 43 (2000)

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Valuation Penalties

- The determination whether a penalty applies is made on a property by property basis
  - Thus, different penalties could apply to different pieces of property
  - See *Estate of True v. Commissioner*, T.C. Memo 2001-67, aff'd, 390 F.3d 1210 (10th Cir. 2004)

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Valuation Penalties (cont.)

- Four Penalties - two in the gift tax context and two in the income tax context. These "triggers" are mathematical:
  - Substantial Valuation Misstatement (income tax)[1]
  - Substantial Estate or Gift Tax Valuation Understatement[2]
  - Gross Valuation Misstatement (income tax)[3]
  - Gross Estate or Gift Tax Valuation Understatement[4]

1. Return value is 150% or more of the correct value - 20% penalty.
2. Return value is 65% or less of the correct value - 20% penalty.
3. Return value is 200% or more of the correct value - 40% penalty.
4. Return value is 40% or less of the correct value - 40% penalty.

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Taxpayer Valuation Penalties

- Estate and Gift Tax Understatement of Value
  - Substantial Valuation Misstatement
  - There is a 20% penalty of the portion of the underpayment of tax attributed to undervaluation if the value on the estate or gift tax return is 65% or less of the amount determined to be correct
    - Section 6662(a), (b)(5), (g)
- Gross Valuation Misstatement
  - There is 40% of the tax attributable to the undervaluation if the amount reported on the estate or gift tax return is 40% less of the value determined to be correct
    - Section 6662(h)(1), (2)(C)
  - There is no penalty if the underpayment of tax is $5,000 or less
    - Section 6662(g)(2)

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Disclosure

- There is no disclosure exception for any of the valuation misstatement penalties
- Comment
  - A disclosure exception would be "too good to be true"
  - The penalty would rarely apply (*i.e.*, I am disclosing the fact that the value on a form is likely wrong)
- Reasonable cause exception can apply

Reasonable Cause

- A showing of reasonable cause and good faith avoids the estate and gift tax penalties
  - Section 6664(c)(1)

Income Tax Overstatement of Value e.g., a Charitable Contribution

- Substantial Valuation Misstatement
  - There is a 20% penalty applicable to any underpayment attributable to a Substantial Valuation Misstatement
    - Section 6662(b)(3)
  - A substantial valuation misstatement occurs if the value (or adjusted basis) of any property claimed on a return claimed income is 150% or more of the correct amount
    - Section 6662(e)
  - The penalty is not imposed unless the misstatement results in an underpayment of greater than $5,000 ($10,000 for a C-corporation)
    - Section 6662(b)(2)

Gross Valuation Misstatement

- There is a 40% penalty in the case of a Gross Valuation Misstatement.
- A Gross Valuation Misstatement occurs if the value of the property is 200% or more of the correct value section.
- The standard is automatically met if the correct value is zero.
  - Treas. Reg. Section 1.6662-5(g).
- Example
  - Donor claims a deduction under Section 170 for the donation of property to a qualified charity

Reasonable Cause and the Income Tax Valuation Penalties

- A reasonable cause exception under Section 6664 can apply when the underpayment is attributable to a substantial (but not a Gross) understatement with regard to a charitable contribution if the following occurs:
  - The claimed value of the property is based upon a qualified appraisal by a qualified appraiser;
  - The taxpayer also made a good faith investigation of the value of the contributed property; and
  - The taxpayer acted with reasonable cause and in good faith
    - Section 6664(c)(3)

Comment: Review the definitions of a qualified appraiser and appraisal in Treas. Reg. Section 1.170A-13(c)(3) and (5)

Penalty for Erroneous Refund Claims — Section 6676

Penalty for Erroneous Refund Claims (Section 6676)

- Penalty equal to 20% of the excessive amount claimed unless:
  - It is shown that there is reasonable cause for the claim for the excessive amount.
  - Assume reasonable cause is the same as under Section 6664.

Comment: Reasonable cause is a defense.

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CONCLUSION

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