

12:05 – 12:55 p.m.

Retention, Post-COVID-19, Company Culture & Labor Shortages

Melodi Bunting, CPA, CMA, CGMA, MBA, Senior Manager,
Wegner CPAs

Angela Wurtz, PHR, Recruiting Manager, Wegner CPAs



Retention, Post COVID, Company Culture, & Labor Shortages

Presented by Angela Wurtz



Angela Wurtz

Recruiting Manager, Wegner CPAs



Angela has been in the HR field, with an emphasis on Talent Acquisition, for the last 15 years. She has recruited for a variety of industries and roles including healthcare, manufacturing, business consulting, and public accounting. She earned her Bachelor of Science degree in Business Management with a concentration in Human Resources Development and is also PHR certified.



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Melodi Bunting

Senior Manager, Advisory Services Wegner CPAs



Melodi returned to public accounting when she joined Wegner CPAs' in 2014 after teaching in higher education, consulting with not-for-profits, and preparing consolidations and international reporting for a retailer. While at Wegner she has been developing and teaching a variety of internal and external training opportunities as well as working with the audit team performing audits, reviews and advisory services.



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Agenda

- Retaining and attracting talent
- Remote work and company culture
- Work-life balance
- Employer trends post COVID?
- Status of the current labor market
- The future labor market



How do you retain and attract talent in this market?

RETAIN

- Hybrid work options is becoming mainstream!
- Manager's role are changing.
- Be ok with change – evolve with changing workplace trends



How do you retain and attract talent in this market?

ATTRACT

- Be where the emerging talent is
- Interview and hire efficiently
- Make recruiting a team effort



Remote work is here to stay – and there are benefits!

Happier
employees

Lower
overhead
costs

Improved
recruiting

Less
tension

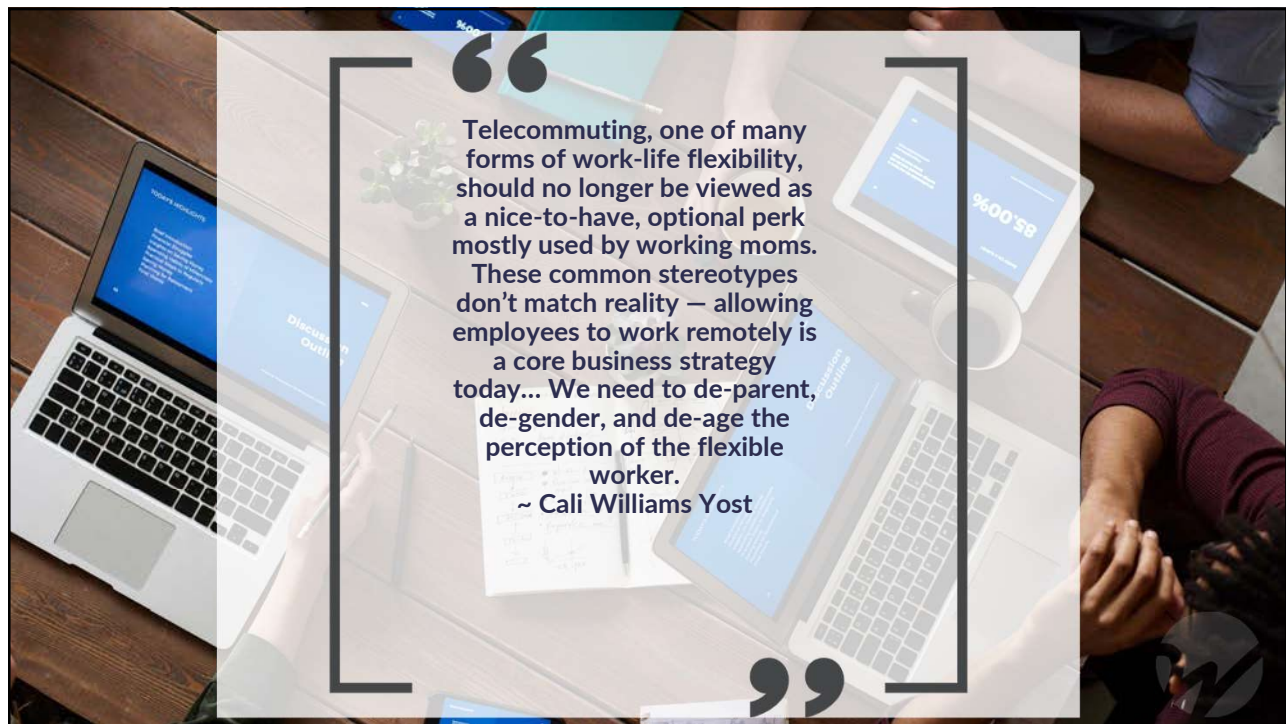
Why is
leadership
concerned with
remote work?



COLLEAGUES
AND TEAMS
BEING SILOED
FROM EACH
OTHER



COLLEAGUES
FEELING LESS
CONNECTED
WITH ONE
ANOTHER.



What can employers do to keep remote workers engaged?

Communication

Expectations

Accountability

Culture

Post COVID trends

- Remote work is here to stay
- Talent shortage
- Shorter work weeks
- Health & well-being



Current labor market

- Unemployment was 3.5% in September
- Increased competition for workers
- Employers are trying to figure out how to keep up with inflation
- Burnt out employees



Future labor market

- Number of job seekers will increase
- Preference for remote work
- Rise of digitalization
- Need to hire more creatively



Contact Us



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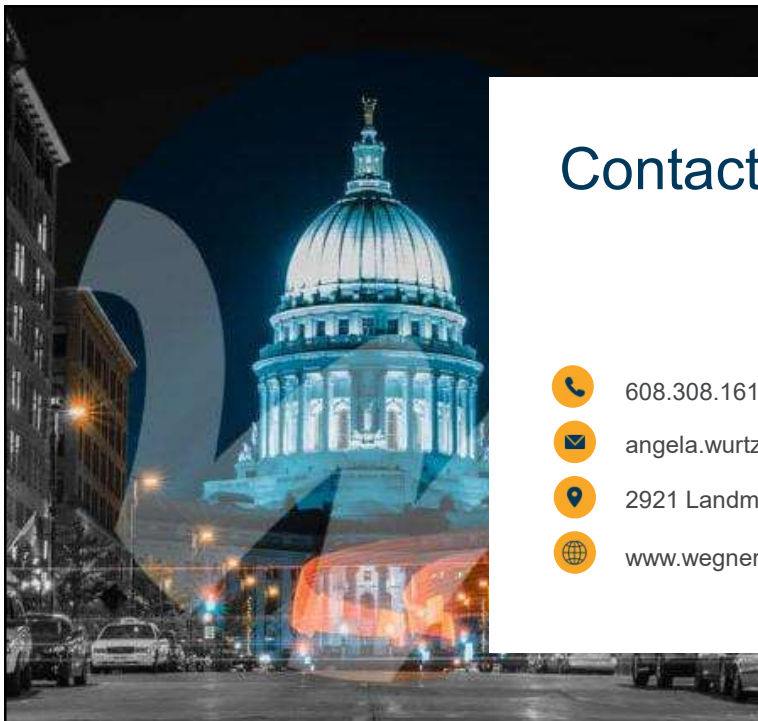
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THANK YOU



1:05 – 1:55 p.m.

ESG State of Play: An Introduction to ESG

Karen Baum, CPA, CFE, Sustainability & ESG Services Leader,
BDO USA LLP

WICPA ACCOUNTING & AUDITING
CONFERENCE:

ESG State of Play

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With You Today



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Activating Sustainability

BDO inspires, educates and assists our clients establish, expand and report on their progress on sustainable business practices.

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LEVEL SETTING:
What is ESG?
What are ESG's
Market Drivers?

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ESG Will Drive Reporting & Disclosure

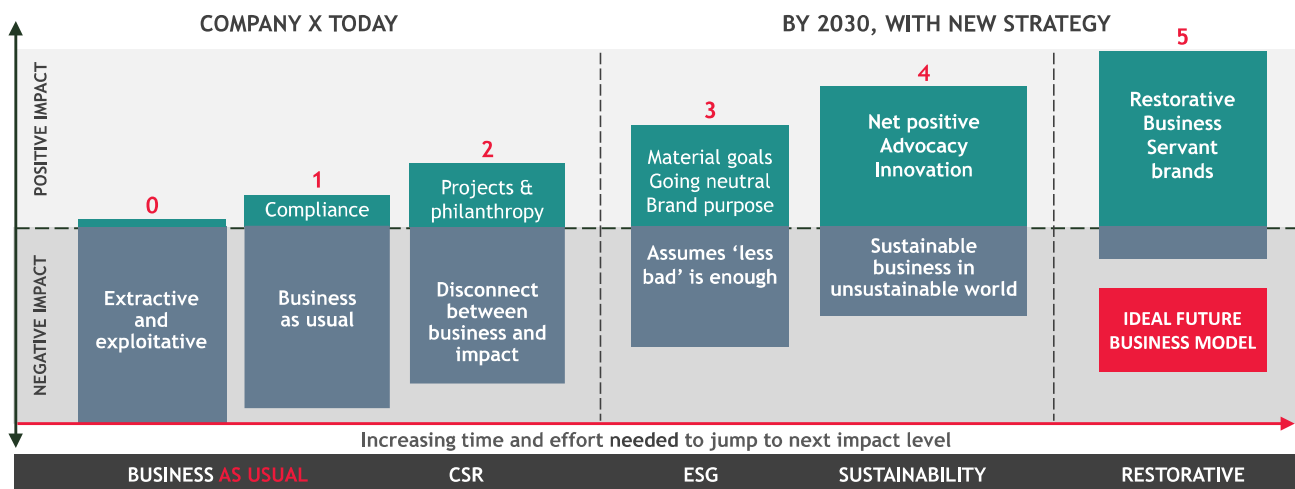


This is not intended as an all-inclusive list of ESG factors and will vary in relevance and importance by company

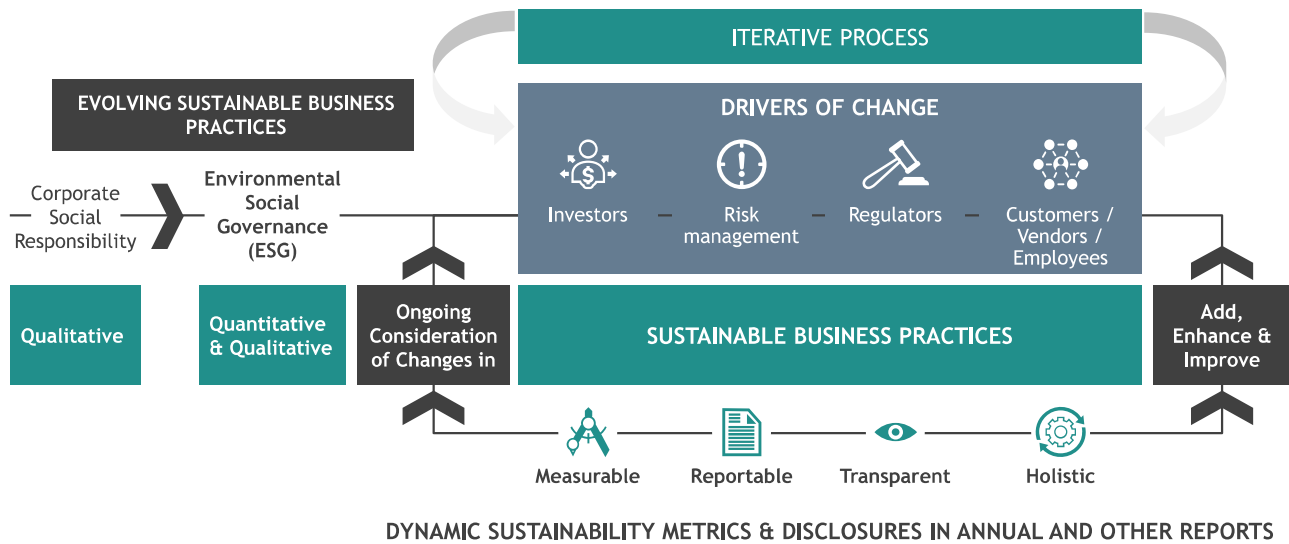
... AND CORPORATE VALUE



The Sustainability Leadership Journey



How Sustainability Is Changing the Business Landscape



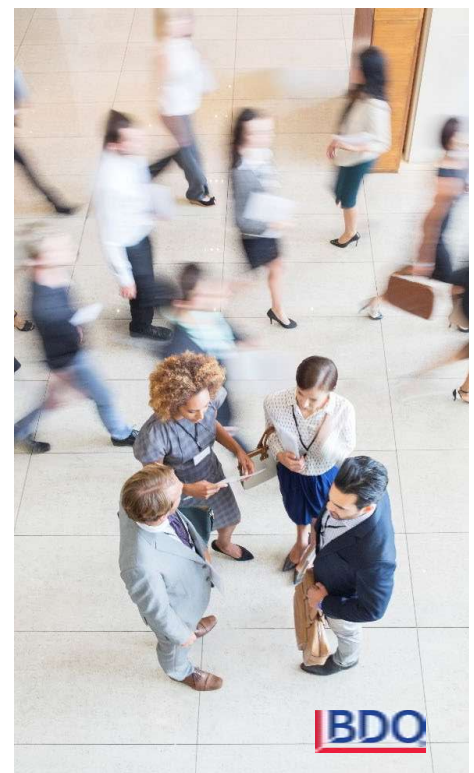
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ESG: Market and Stakeholder Drivers

- ▶ Private Equity and broader investor community
- ▶ Sustainable lending and green bonds
- ▶ Lenders basing access to capital/rates on ESG rating/maturity
- ▶ Transparency surrounding ESG factors and voluntary disclosures
- ▶ Client demands for alignment with their ESG commitments
- ▶ Competitive and supply chain pressures
- ▶ Executive compensation tied to ESG performance
- ▶ Employee expectations
- ▶ Public pressure/reputational and brand risk
- ▶ Expanding regulation/pressure for disclosure
- ▶ Shareholder activism
- ▶ Environmental and social activism
- ▶ ESG rating agencies

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Sustainability Is Transformational: Some Examples ...



ENERGY TRANSITION

Corporations continue to make large carbon removal commitments to help fight climate change. Microsoft and Alphabet collectively pledged to invest \$400 million in carbon removal programs and Salesforce announced a new commitment to invest \$100 million in the purchase of carbon credits.



CIRCULAR ECONOMY

Walmart, the world's largest retailer has set the goal to become a regenerative company with net zero emissions by 2040. HP and Nestle, among others, commit to the use of 75% and 100%, respectively, recycled materials in product packaging by 2025.



GENDER EQUALITY

The Council and European Parliament announced an agreement on a new law setting targets for EU companies to improve gender balance on corporate boards. The new directive would promote increased representation of women on boards.



SUSTAINABLE FINANCE

The SEC proposed two rule changes that would prevent misleading or deceptive claims by U.S. funds on their ESG qualifications and increase disclosure requirements for those funds.



SUPPLY CHAIN

EU announced new rules requiring companies to integrate due diligence procedures into policies to identify actual or potential adverse human rights and environmental impacts, prevent or mitigate potential impacts and end or minimize actual impacts.



CORPORATE REPORTING

The comment period for the SEC's proposed new climate disclosure requirements for public companies recently concluded. The proposed EU Corporate Sustainability Reporting Directive (CSRD) will require comprehensive ESG reporting for public and private companies meeting certain size requirements. The International Sustainability Standards Board (ISSB) recently launched a consultation on its first two proposed standards.



Benefits of Adopting a Sustainability Program



Bolsters and reinforces corporate image and reputation, and improves employee and customer retention



Defines an innovative vision of the business by identifying non-financial drivers



Improves access to credit and the ability to attract investment



Allows you to compete with those already disclosing their sustainability focus



Drives true corporate value creation and simultaneously benefit the planet



Satisfies the expectations of stakeholders that you are maintaining your social license to operate



Systematically reports the link between strategy and financial performance including impacts of ESG factors



Identifies monitors and manages non-financial risks correctly



Improves data quality for more effective information management and decision making






The ESG Journey

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BEFORE YOU TAKE THE LEAP

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KEY CONSIDERATIONS before beginning your ESG journey:



Embrace stakeholder capitalism



Utilize change management best practices



Recognize that lack of internal leadership alignment is a deal killer



Define team roles as a critical first step



Know that it's not a one and done process; it is iterative in nature



Remember that it's a marathon, not a sprint



Consider costs, both financial and human capital

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BDO's SUSTAINABILITY INTEGRATION ROADMAP



PHASE OF THE ESG JOURNEY



LEVEL OF GOVERNANCE



Getting Started

| COACH & FRAME | |
|---------------|---|
| | Provide sustainability awareness training |
| | Identify stakeholder requirements and other inputs to develop ESG strategy |
| | Define the Board's role |
| | Perform maturity / material risk assessment |
| | Prioritize urgency/importance alongside effort/value |
| | Develop a sustainability roadmap including selecting reporting framework(s) |
| | Ensure internal controls in place for ongoing monitoring & compliance |
| | Conduct iterative enhancements |

| SAMPLE ACTIVITIES | |
|-------------------|--|
| ▶ | Engage with internal and external stakeholders on sustainability issues |
| ▶ | Perform materiality analysis/gap assessment |
| ▶ | Define oversight responsibility among the board and/or within committees of the board |
| ▶ | Analyze business plans according to the Sustainable Development Goals (SDGs) and other frameworks |
| ▶ | Design / improvement of sustainability governance |
| ▶ | Develop sustainability policies and operational plans |
| ▶ | Update/development of the Code of Ethics |
| ▶ | Develop of Code of Conduct for suppliers |
| ▶ | Source education for employees and leadership on evolving sustainability and ESG matters |
| ▶ | Produce sustainability report using acceptable frameworks (e.g., WEF/IBC, GRI, VRF (SASB/IIRC), GBS, AA1000) |



Perform an ESG Readiness Assessment

| | |
|--|--|
| | What qualitative and quantitative information are we currently sharing internally/externally? |
| | Who is and how are we compiling this information? |
| | What is the knowledge level and learning being provided? |
| | What are we not yet doing/measuring/communicating that we should consider? (Gap analysis) |
| | Do we have adequate policies & procedures or do these need to be developed? |
| | How is what we defined in our scoping aligned with our ST/LT business strategy (ultimate objective)? |
| | Are the company's internal stakeholders ready to begin the journey? |
| | Have appropriate resources, such as financial or human capital, been allocated? |

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ESG Strategy Development

| | |
|--|--|
| | Stakeholder Engagement: Determine relevant stakeholders and what matters to them (internally/externally) |
| | Materiality Assessment: Define specific ESG risk/opportunities material to your business |
| | ESG Roadmap: Define your strategy for prioritization and action; set goals and KPIs |
| | Data Collection and Controls: Identifying processes, systems and controls over data |
| | Reporting: Define reporting needs and identify standard(s) and framework(s) |

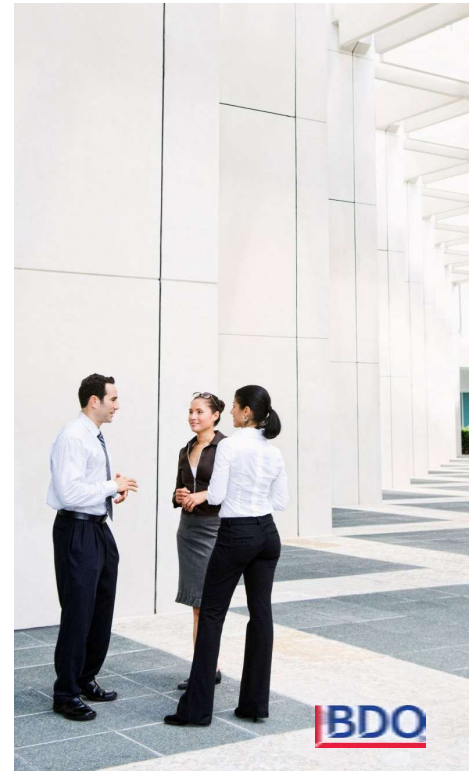
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Define Stakeholders

| | |
|---|---|
|  | Shareholders |
|  | Employees |
|  | Customers |
|  | Strategic Partners |
|  | Vendors/Suppliers/Lenders/Insurers/Sureties |
|  | ESG Raters and Proxy Advisors |
|  | Regulators |
|  | Communities |

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Consideration of Materiality

IN THE CONTEXT OF FINANCIAL REPORTING:

IAS 1, Financial Statement Presentation

Information is material if omitting, misstating or obscuring it could reasonably be expected to influence the decisions that the primary users of general-purpose financial statements.

FASB Conceptual Framework - Concept Statement 8

Relevance and materiality: Relevance of information as being useful to investors while materiality is entity specific such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.

SEC / U.S. Securities Law

Material information is information that a reasonable investor would consider important; an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.

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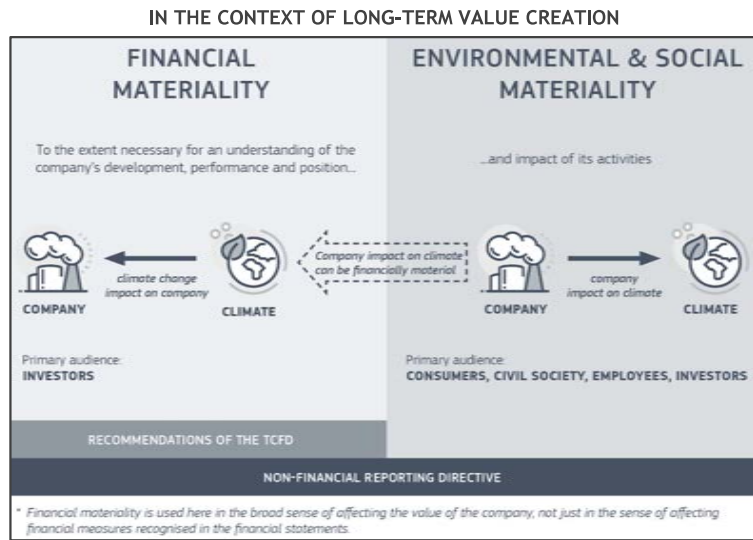
Consideration of Materiality

DOUBLE MATERIALITY

The concept of double materiality acknowledges that a company should report simultaneously on sustainability matters that are:

- ▶ financially material in influencing business value
- ▶ material to the market, the environment, and people

The Double Materiality perspective of the Non-Financial Reporting Directive.



Source: [Guidelines on Reporting Climate-related Information](#)

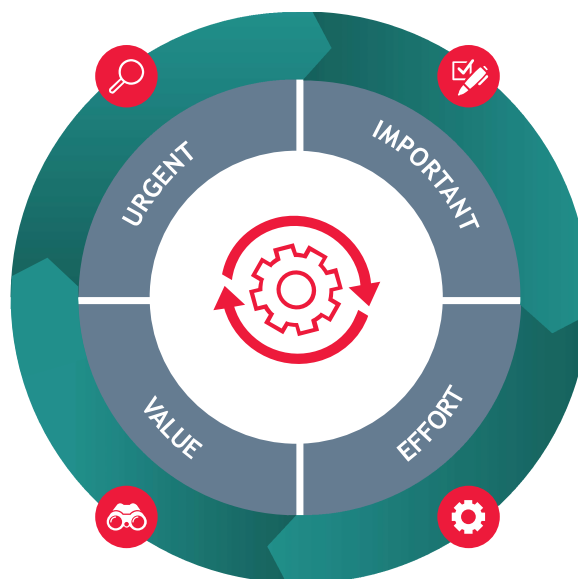


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Prioritize Action

- ▶ Risk Drivers
- ▶ Competition
- ▶ Regulation
- ▶ Disruption
- ▶ Legal

- ▶ Opportunities
- ▶ New business
- ▶ Talent
- ▶ Brand



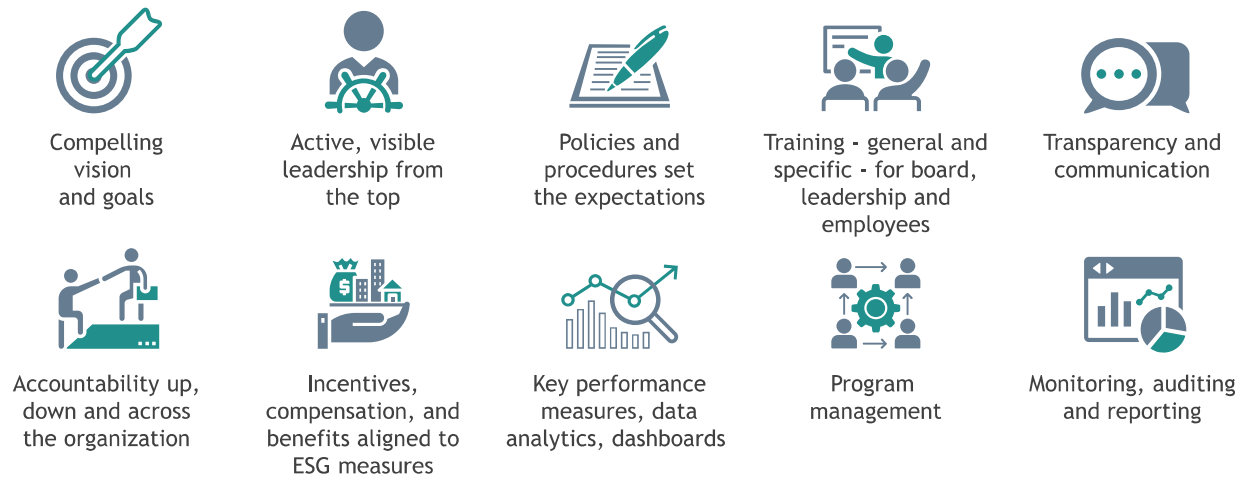
- ▶ S/T vs. L/T Focus
- ▶ Change management
- ▶ Strategy
- ▶ Emerging areas
- ▶ Resilience

- ▶ Resources
- ▶ Cost
- ▶ Advisors
- ▶ Systems



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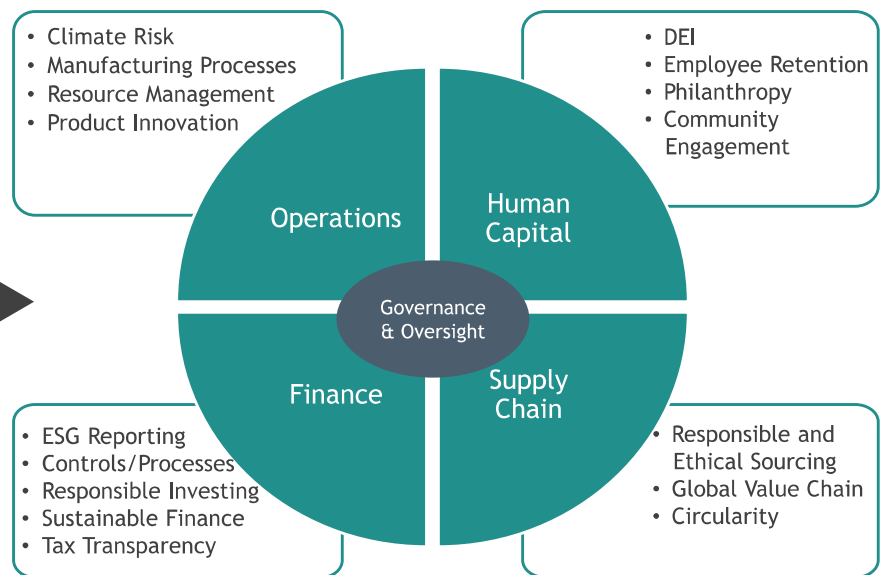
10 Key Elements of an Effective ESG Program



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Functions Most Often Affected By the ESG Journey



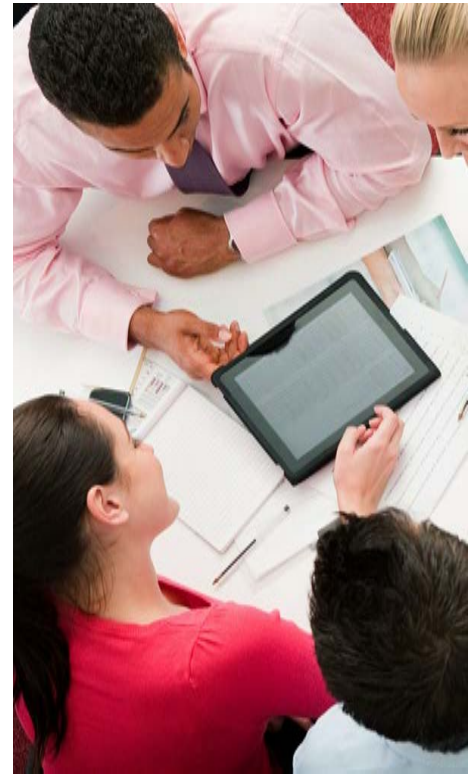
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HUMAN CAPITAL: Key ESG Impact Considerations

-  Employees look to work for employers who demonstrate alignment with their values
-  Investments in a diverse and equitable work environment is needed to remain competitive
-  Increased scrutiny on disclosure of DEI and HCM data
-  Stakeholder pressure to integrate ESG into executive compensation
-  Issues like labor rights and pay equity may lead to regulatory, legal or reputational concerns

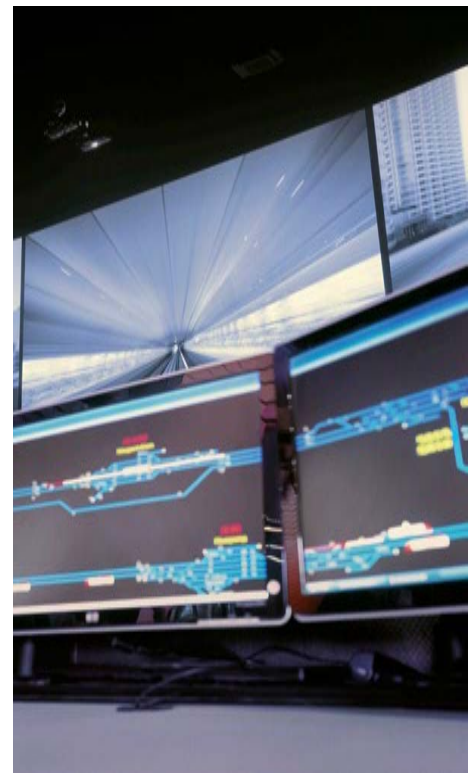
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OPERATIONS: Key ESG Impact Considerations

-  Anticipated regulation mandating climate risk disclosures drives need to develop remediation strategies
-  Pressure for market transitions away from fossil fuels
-  Increasing costs for electricity, fuel and raw materials threaten margins
-  Business impact on natural ecosystem and management of biodiversity
-  Consumer demand for sustainably manufactured products drives need for product innovation

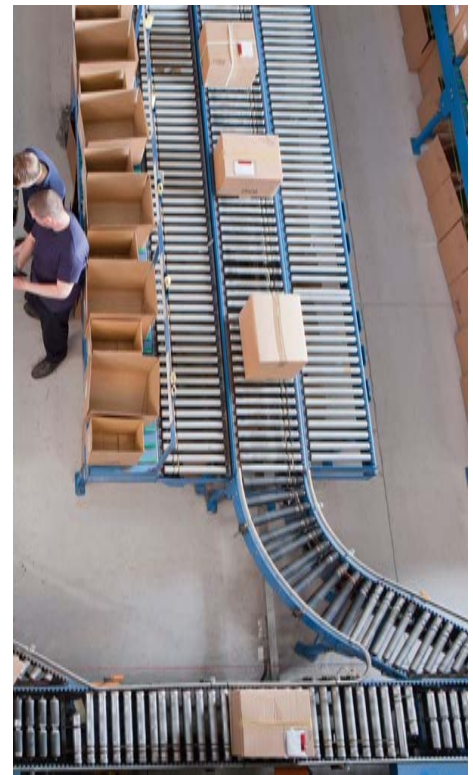
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SUPPLY CHAIN: Key ESG Impact Considerations

-  Scrutiny on carbon intensity and human rights risks within supply chains
-  Disruption of operations and impact on business continuity due to extreme weather
-  Availability and accessibility issues due to global political instability
-  Ethical sourcing, as well as considerations of impacts of operations on local communities can destabilize supply chains
-  Addressing inefficiencies in logistics and warehousing to diversity in sourcing can have significant supply chain impacts

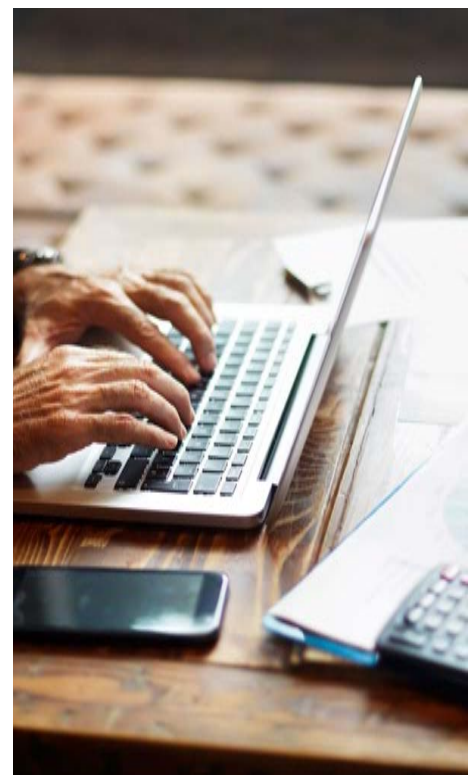
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FINANCE Key ESG Impact Considerations

-  Total tax transparency is an expectation
-  Anticipated ESG regulatory disclosures may mandate reporting and attestation of non-financial data
-  Rise in impact investing and risk of stranded assets
-  Reporting of non-financial data requires collection, management and monitoring of new data sets and controls and processes to ensure integrity
-  Level of sustainable maturity can directly impact access to debt and equity capital

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Unlocking a Successful ESG-Driven Tax Strategy

Aligning the tax function with an overarching ESG strategy across the business is a heavy lift.

To build and implement a responsible tax program will take time and requires careful consideration of an organization's overall **approach to tax**, **tax governance**, and **total tax contribution**.

Whether you are just beginning or at the stage of reassessing your approach based on changing market conditions, updates to your ESG strategy, or regulations, the BDO Tax ESG Cipher to the right can be used to guide these critical considerations and help ensure tax is meaningfully incorporated in ESG strategy.

The process should be iterative over time and when implemented successfully, will drive **improved decision-making on risk mitigation**, **strengthen risk awareness** and **increase transparency and accountability**.



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Sustainability Reporting and Attestation

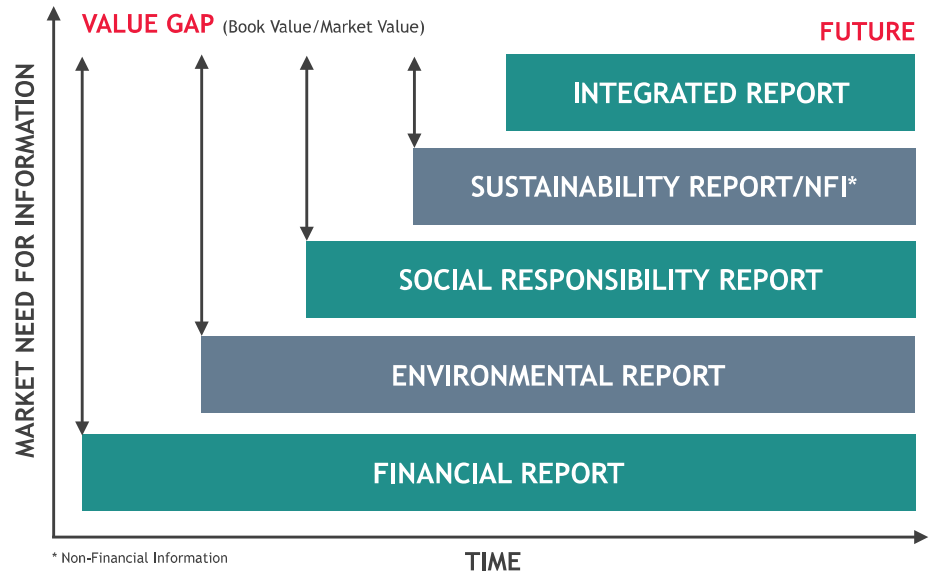
May include both qualitative discussions and qualitative metrics such as measures of a company's performance against ESG risks, opportunities and related strategies

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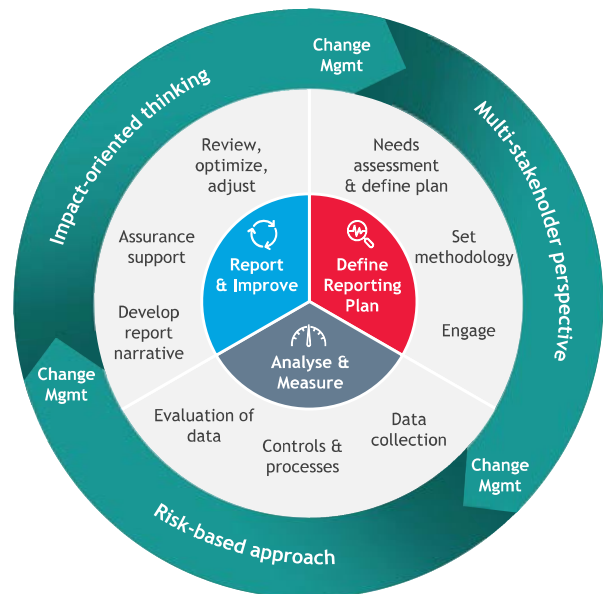
REPRESENTATION OF VALUE OVER TIME

Evolution of Reporting



Reporting Process Phases

Integrating sustainability into a business is a transformation journey and ongoing process of monitoring, modification and rethinking 'how' you can ultimately embed sustainability across the organization.



Sustainability Reporting and Attestation Readiness Guide

BDO has prepared a practice aid of iterative considerations for management and boards to help them assess a company's readiness to report out on its sustainability strategy:

Taking Inventory

- ☐ Materiality assessment
- ☐ Competitive landscape
- ☐ Corporate story
- ☐ Reporting standards & frameworks
- ☐ Current state assessment

Establishing Governance Oversight

- ☐ ESG roles
- ☐ ESG goals/objectives
- ☐ Third party resources
- ☐ Progress and accountability
- ☐ Continuing education
- ☐ Board strategy & ERM agenda

ESG Reporting Readiness

- ☐ Reporting requirements
- ☐ Quantitative measures and data
- ☐ Data collection (processes, policies, procedures)
- ☐ Control effectiveness
- ☐ Qualitative information
- ☐ Draft disclosures
- ☐ Review as reasonable shareholder
- ☐ Third party attestation value



Access publication [here](#)

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Examples of ESG Global Regulatory Landscape

U.S.

- On June 17, 2022, the [comment period ended](#) for the SEC [proposed](#) rules mandating climate-related disclosures by U.S. listed companies
- In May 2022, the SEC [proposed](#) rule changes that would prevent misleading or deceptive claims by U.S. funds on ESG qualifications and increase disclosure requirements

IISB (International Sustainability Standards Board)

- On July 29, 2022, [the comment period ended](#) for two ISSB proposals on sustainability reporting standards, one with respect to general standards and the second with respect to climate. ISSB will review at September 2022 meeting

EU Council

- In February 2022, [adopted position](#) on the Corporate Sustainability Reporting Directive (CSRD)
- In February 2022, the European Commission published [its proposal](#) for a Directive on Corporate Sustainability Due Diligence (CSDD). The Directive sets mandatory human rights' supply chain due diligence rules for large companies headquartered or operating in the EU
- In May 2022, the European Financial Reporting Advisory Group (EFRAG) [released a sustainability standards draft](#), setting out the proposed rules and requirements for EU ESG reporting under the CSRD

Canada

- In April 2022, [mandated reporting](#) of climate-related financial risks for federally-regulated financial institutions

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ESG Frameworks / Standards

| Framework Name | Where to Report | Focused Area | Information to Report | Topic-specific disclosures or multi-topic? | Industry Specific or Industry agnostic? | Standard/ Framework/ Guidelines | Target Reporter | Primary Audience |
|--|---|---------------------------------------|---|---|---|---------------------------------|---------------------------------------|---|
| Carbon Disclosure Project (CDP) | CDP's Online Platform | Environment/ Governance | <ul style="list-style-type: none"> Climate Change Forest Water Security Supply Chain | Environmental Specific | Industry-Specific | Guidelines | Companies, Cities, States and Regions | Investors, buyers, other stakeholders |
| Sustainable Development Goals (SDG) | Sustainability Report | Environment/ Social/ Governance | <ul style="list-style-type: none"> 17 SDG Goals | Multiple disclosures | Industry-agnostic | Guidelines | All Companies | Multiple stakeholder groups |
| Climate Disclosure Standards Board (CDSB) | Mainstream reports, such as annual reports, 10-K filing, or integrated reports. | Environment/ Social | <ul style="list-style-type: none"> Climate Water Biodiversity Social disclosures | Multiple disclosures | Industry-Specific | Guidelines | Companies, Cities, States and Regions | Investors, buyers, other stakeholders |
| International Integrated Reporting Council (IIRC) | Stand alone integrated report | Environment/ Social/ Governance | <ul style="list-style-type: none"> Organizational overview Risks and opportunity Strategy Performance Outlook Basis of Presentation | Framework which covers all financial and non-financial issues | Industry-agnostic | Framework | Public Companies | Investors and multiple stakeholder groups |
| Task Force on Climate-related Financial Disclosures (TCFD) | Annual Financial filings (Annual Report) | Environment/ Governance | <ul style="list-style-type: none"> Governance Strategy Risk Management Metrics and Target | Climate change specific | Industry-agnostic (+ some sector specific guidance) | Framework | All Companies | Investors, lenders, and insurers |

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ESG Frameworks / Standards

| Framework Name | Where to Report | Focused Areas | Information to Report | Topic-specific disclosures or multi-topic? | Industry Specific or Industry agnostic? | Standard/ Framework/ Guidelines | Target Reporter | Primary Audience |
|--|--|---------------------------------------|--|---|---|---------------------------------|---------------------------|------------------------------------|
| WEF-IBC | Mainstream report (annual report or proxy statements)/ Sustainability Report | Environment/ Social/ Governance | <ul style="list-style-type: none"> Principles of Governance Planet People Prosperity | Multiple disclosures | Industry agnostic | Framework | All companies | Investors and multiple stakeholder |
| Principles of Responsible Investment (UNPRI) | public and private Transparency Reports and Assessment Reports | Environment/ social | <ul style="list-style-type: none"> 6 principals Climate Change Human Rights | Topic-specific relating to investment impacts such as climate-related impacts | Financial sector | Framework | All signatories companies | Investors |
| Global Reporting Initiative (GRI) | Corporate sustainability report | Environment/ social/ Governance | <ul style="list-style-type: none"> General disclosures Economics Environment Social | Multiple standards across economic, environment and social | Industry-agnostic (+ some sector specific guidance) | Standard | All companies | Multiple stakeholder groups |
| Sustainability Standards Board (SASB) | SEC form 10K, 20F filings | Environment/ social/ Governance | <ul style="list-style-type: none"> Environment Social capital Leadership and governance Business model and innovation Human capital | Multiple disclosures across economic, environment and social | Industry specific | Standard | All companies | Regulators |
| UN Global Compact | Annual communication on progress (COP) | Environment/ social/ Governance | <ul style="list-style-type: none"> Human rights Labor Environment Anti-corruption | Multiple disclosures across economic, environment and social | Industry specific | Standard | All companies | Regulators |

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GET TO KNOW TARGET CO.



Rating Agencies / Index

| Rating Agencies | Total Companies Covered | Source of Info | Number of Topics | Companies Involvement | Scoring Scale | Update Frequency |
|---|-------------------------|--|---------------------------|---|--|--|
| MSCI | Over 14,000 | Disclosures of the companies Database (government, science, NGO's) News and media | 35 | Companies are invited to verify the data | AAA (Leader) to CCC (Laggard) | Ongoing monitoring, annual in-depth review |
| S&P / DJSI | Over 10,000 | Disclosures of the companies | 20-30 | Companies fill out questionnaire | 0 (Lowest Risk) -40+ (Highest Risk) | Yearly |
| Sustainalytics / Morning Star | Over 14,000 | Disclosures of the companies Media NGO | 20 | Companies are invited to provide feedback and additional data | 0 (Lowest Risk) -40+ (Highest Risk) | Ongoing monitoring, annual in-depth review |
| ISS | Over 7,300 | Disclosures of the companies Media NGOs | Up to 100 | Companies are invited to provide feedback and additional data | A+ (Highest Performance) to D- (Lowest Performance) | Yearly |
| Reprisk | Over 200,000 | Media Other public information Explicit exclusion From corporate reporting | 73 | No interaction | 0(Lower Risk)-100 (Highest Risk) AAA (Low ESG risk Exposure) to D (High Risk Exposure) | Daily Update |
| Bloomberg | Over 11,800 | Disclosures of the companies Multiple ESG third party providers | 14 (includes 2100 fields) | Companies can request updates at any time | 1-100 | Daily Update |
| CDP | Over 13,000 | Disclosures of the companies / Annual reporting process | 3 | Companies fill out questionnaire | A(Leadership) to D- (Disclosure) F = Failure to provide sufficient info. | Yearly |
| EcoVadis | Over 90,000 | Customer-provided documentation Third-party endorsements (certifications, labels, etc.) News, Watchlist etc. | 21 | Companies fill out questionnaire | 1 (Insufficient)-100 (Outstanding) | Yearly |

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The Road to Reporting Convergence



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ISSB Launches Consultation on First Two Proposed Standards

- ▶ On March 31, 2022, the ISSB issued its first two exposure drafts on IFRS Sustainability Disclosure Standards:
 - [IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information](#)
 - [IFRS S2 Climate-related Disclosures](#)
- ▶ The proposals have been developed in response to requests from G20 leaders, the International Organization of Securities Commissions (IOSCO) and others for enhanced information from companies on sustainability-related risks and opportunities.
- ▶ The proposals set out requirements for the disclosure of material information about a company's significant sustainability-related risks and opportunities that are necessary for investors to assess a company's enterprise value and are not limited only to climate-related.
- ▶ The deadline for comments on both proposals was July 29, 2022.



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European Union

CSRD Proposal

The European Commission's proposal revises the non-financial reporting directive (NFRD) from 2014 and will ensure the robustness of companies' commitments by introducing the following new features:

- ▶ an extension of the scope to all large companies and companies listed on a regulated market (except listed micro-companies)
- ▶ a certification requirement for sustainability reporting
- ▶ more detailed and standardized requirements on the information to be published by companies
- ▶ improved accessibility of information, by requiring its publication in a dedicated section of company management reports
- ▶ First standards to be adopted by October 2022
- ▶ Refer [here](#) for more information

CSRD Timing and Scope

Year ending 31 December 2024

- ▶ Companies within scope of current NFRD (approx. 12,000)
 - Large PIEs with >500 employees

Year ending 31 December 2025 (approx. 50,000)

- ▶ All listed companies, and all companies meeting two of the following criteria
 - >250 employees
 - >EUR 40m turnover
 - >EUR 20m assets

Later:

- ▶ Listed micro entities
 - <10 employees
 - < EUR 2m turnover or assets

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European Union

CSDD Proposal

The proposed CSDD directive shall apply only to EU and non-EU companies of a considerable size and economic power - not SMEs, as defined in the EU. Would require companies to:

- ▶ integrate due diligence into their company policies and have in place a due diligence policy;
- ▶ identify actual and potential adverse human rights and environmental impacts;
- ▶ prevent or mitigate potential adverse impacts, and bring to an end or minimize actual impacts;
- ▶ establish and maintain a complaints procedure;
- ▶ monitor the effectiveness of the due diligence policy and measures; and.
- ▶ Annual report describing due diligence, adverse impacts, actions.

The directive sets out several corporate governance provisions, including directors' duties to set up and oversee the implementation of due diligence and to integrate it into the corporate strategy. For further information on the proposal, refer [here](#) and [here](#).

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CSDD Timing and Scope

Legislation expected to be finalized

- ▶ H1 2023

Two years after legislation finalized:

- ▶ EU companies
 - >500 employees
 - >EUR 150m net worldwide turnover
- ▶ Non-EU companies
 - >EUR 150m net EU turnover

Four years after legislation finalized

- ▶ EU companies
 - >250 employees
 - >EUR 40m net worldwide turnover if 50%+ generated in high risk sectors
- ▶ Non-EU companies
 - >EUR 150m net EU turnover if 50%+ generated in high risk sectors



REPORTING LANDSCAPE UPDATES

Current Disclosure in U.S.

PUBLIC COMPANIES

- ▶ Standalone reports including corporate social responsibility (CSR)/sustainability reports
- ▶ Company websites & marketing materials
- ▶ MD&A sections of annual & quarterly filings
- ▶ Earnings calls
- ▶ Proxy statements and 8-Ks

PRIVATE COMPANIES

- ▶ Nascent with respect to sustainability reports
- ▶ Sustainability statements, Code of Ethics and Reports have begun surface on company websites



Investors seeking ESG information do not necessarily expect any or all of that information to be presented in SEC filings, and sustainability disclosure on corporate websites may provide effective vehicles for this disclosure to investors.



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SEC Proposed Rules to Enhance and Standardize Climate-Related Disclosures for Investors

On March 21, 2022, the SEC proposed rule changes requiring certain climate-related disclosures. The disclosures are modeled in part on the [TCFD disclosure framework](#) and draws upon the [Greenhouse Gas \(GHG\) Protocol accounting standards](#). The SEC reporting requirements would be phased in based on filer status beginning in the year following the effective date, with further phase in for attestation requirements. The comment period was extended to June 17, 2022.

Climate-Related Disclosure:
Reg S-K Subpart

Climate-Related Disclosure:
S-X Footnote

Other Climate-Related Disclosures:
Oversight, governance, transition plan, scope 1, 2 and 3 metrics, etc.



- ▶ Click [here](#) to access the proposed rule
- ▶ Click [here](#) to access the fact sheet
- ▶ Click [here](#) to access the SEC's press release
- ▶ Click [here](#) to access speeches and statements from Chair Gensler and Commissioners
- ▶ Refer to BDO's Insights [here](#).

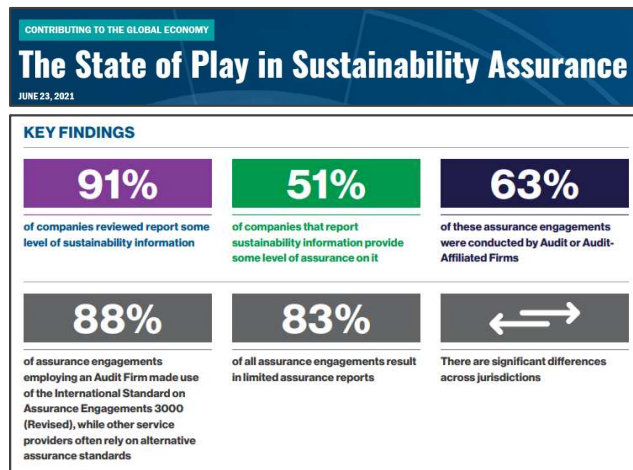
SEC Proposed Rules to Enhance and Standardize Climate-Related Disclosures for Investors

Phase-In Periods and Accommodations

Following tables assume proposed rules adopted with an effective date of December 2022 and filer has a December 31st fiscal year-end:

| Registrant Type | Disclosure Compliance Date | | |
|---|---|--|----------------------------------|
| | All proposed disclosures, including GHG emissions metrics: Scope 1, Scope 2, and associated intensity metric, but excluding Scope 3 | GHG emissions metrics: Scope 3 and associated intensity metric | |
| Large Accelerated Filer | Fiscal year 2023 (filed in 2024) | Fiscal year 2024 (filed in 2025) | |
| Accelerated Filer and Non-Accelerated Filer | Fiscal year 2024 (filed in 2025) | Fiscal year 2025 (filed in 2026) | |
| SRC | Fiscal year 2025 (filed in 2026) | Exempted | |
| Filer Type | Scopes 1 and 2 GHG Disclosure Compliance Date | Limited Assurance | Reasonable Assurance |
| Large Accelerated Filer | Fiscal year 2023 (filed in 2024) | Fiscal year 2024 (filed in 2025) | Fiscal year 2026 (filed in 2027) |
| Accelerated Filer | Fiscal year 2024 (filed in 2025) | Fiscal year 2025 (filed in 2026) | Fiscal year 2027 (filed in 2028) |

The State of Play in Sustainability Assurance



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ESG REPORTING ATTESTATION

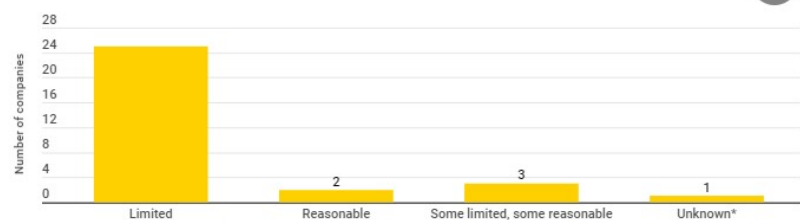
U.S. State of Play: S&P 500

- ▶ 95% of S&P make available sustainability information
- ▶ 51% have had some form of Assurance or verification over ESG metrics
- ▶ 6% had assurance from public company audit firm while 47% had assurance from engineering or consulting firm (non-CPA)

Source: [Center for Audit Quality Review of S&P 500 ESG Reporting](#) as of 6/18/2021

Level of Assurance: Of the companies that had assurance from public company auditors, most of them obtained limited levels of assurance over select information. Three companies obtained limited assurance over some metrics and reasonable assurance over other metrics and two companies obtained just reasonable assurance.

Level of Assurance Provided by Public Company Auditors



*Level of assurance could not be determined from the company's documentation of assurance in its ESG reporting.

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ESG REPORTING & ATTESTATION

The Auditor's Role

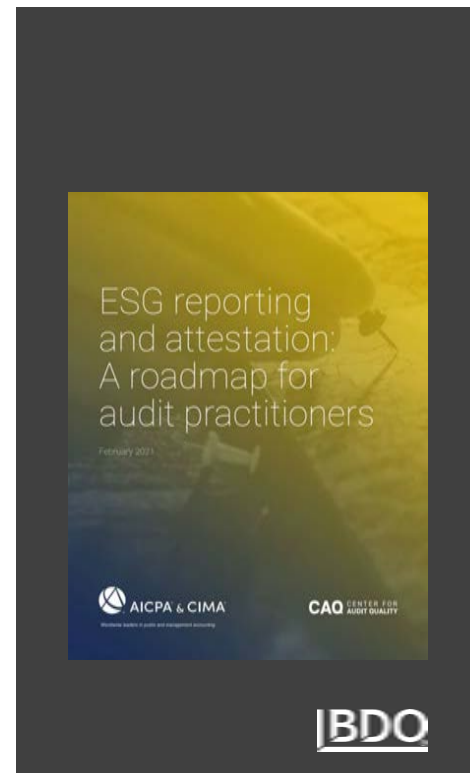
KEY CONSIDERATIONS

- ▶ Scope of subject matter
- ▶ Sufficient/appropriate evidence
- ▶ Reporting criteria to be measured against (e.g., ESG standards/frameworks; custom metrics)?
- ▶ Level of attestation - e.g., exam/review
- ▶ Where/how will ESG information and attestation report be disclosed/used
- ▶ Consistency, comparability, frequency of reporting
- ▶ Appropriate governance and controls over process
- ▶ Materiality
- ▶ Other rules/regulations

UNDERLYING ASSUMPTIONS

- ▶ The building blocks of reliable, comparable and relevant ESG information begin with quality reporting by management.
- ▶ 3rd-party assurance from an independent accounting firm can enhance the reliability of ESG information reported by companies, in a manner similar to the rigorous process that occurs with audits of F/S and ICFR.

Source: [AICPA & CAQ ESG Reporting and Attestation Roadmap](#)



Keeping ESG Reporting Clean

- ▶ Ensure policies, procedures and internal controls.
- ▶ Utilize relevant ESG ratings and reporting frameworks.
- ▶ Consistently represent ESG disclosures and claims.
 - Are we using unclear terms like “sustainable?”
 - Are our labels and logos from accredited organizations?
 - Is there easily accessible evidence provided to support ESG claims?
 - Is the frequency and timing of reporting appropriate, sufficient, consistent and comparable?
 - Is reported information factual or misleading; are standards and metrics “cherry picked?”
- ▶ Verify ongoing monitoring of methodologies and requirements.
- ▶ Compare to peers.

Board and Management Oversight

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BDO

At a Glance - Role of the Board



Establish the tone from the top with respect to ESG



Define oversight responsibility and board committee structure



Identify, monitor and oversee management of non-financial risks correctly



Be alert to controls over data quality for more effective information management, decision-making and reporting



Establish management accountability criteria and integration of ESG objectives into overall corporate strategy



Ensure communication and reporting is reflective of prioritized ESG factors, related objectives and tracking of progress

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BDO

Addressing Stakeholder Expectations of Boards

| Stakeholder | Expectations of the Board |
|------------------|---|
| Investors | Oversee the integration of ESG into operations that support sustainable value creation strategies. |
| Proxy Advisors | Disclose the board's role in overseeing environmental, social and governance issues. |
| Rating Agencies | Ensure management provides up to date information on ESG policies, initiatives and performance. |
| Regulators | Ensure the organization discloses its material ESG risks and impact on the business, and how management is mitigating those risks. |
| Management Teams | Oversee the development and direction of the ESG strategy, goals and objectives to address related risks, including oversight of the controls, policies, processes, metrics, incentives and monitoring processes in executing the strategy. |
| Employees | Establish clear communication and tone of urgency from the top. Hold the management team accountable for carrying out the organization's mission, visions and values while encouraging innovation and ensuring the well-being of all employees. |



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CEO, Management Team and Board Considerations For Proactive & Evolving ESG Risk Management & Oversight

Identifying Business-Relevant ESG Issues

- ▶ Current process and assumptions
- ▶ Competitor analysis
- ▶ Integration into ERM

Prioritizing ESG Risks/Opportunities Based Upon:

- ▶ Materiality assessment/risk tolerance
- ▶ Stakeholder impacts/expectations - engagement
- ▶ Market impact, valuation
- ▶ Decision-useful information

Clearly Define Board Oversight:

- ▶ Identify full board/committee roles
- ▶ Update board charters
- ▶ Consider disclosure of oversight

Tying to Strategy and Value Creation:

- ▶ Establishing short-term and long-term targets, goals and metrics in line with business strategy
- ▶ Assessing resource needs internally/externally
- ▶ Establishing compensation incentives

Selecting Applicable Frameworks and Methodology

- ▶ Assess availability of data
- ▶ Process/internal controls for collecting/integrity of data

Defining Performance Accountability

- ▶ Tracking & monitoring mechanisms

Designing Reliable Reporting

- ▶ Selecting appropriate standards/frameworks
- ▶ Designing controls and processes over ESG data
- ▶ Identifying communication channels - sustainability reports, websites, filings
- ▶ Integrating within financial statements

Maintaining ESG as a Regular Board Agenda Item

- ▶ Defining and formalizing responsibilities among board/committees/management
- ▶ Ensuring continued education on ESG matters

Assessing Need for Third-Party Assurance

- ▶ Compliance
- ▶ Data integrity



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Thank You!

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US ESG EXECUTIVE LEADERSHIP TEAM

ESG Leadership Team



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2:05 – 3:35 p.m.

Crypto & Audit Implications: Trends & Applications for Accounting Practitioners

Dr. Sean Stein Smith, CPA, CMA, CFE, CGMA, *Assistant Professor,*
City University of New York - Lehman College

Blockchain Systems: Audit of the Future

Dr. Sean Stein Smith
City University of New York - Lehman College
Founder - Institute For Blockchain & Cryptoasset Research



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 Fellow - 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)

Quick crypto level-set

How is BTC different from fiat?

Bitcoin

- ▶ Fixed supply (21 million)
- ▶ Requires investment to create new units
- ▶ Not issued by a government or central oversight authority
- ▶ Borderless
- ▶ Cryptographically secured

USD

- ▶ Unlimited supply (printer go brrr)
- ▶ No investment required to increase supply
- ▶ Controlled entirely by central government or central bank
- ▶ Linked to specific nation-state
- ▶ No inherent security

Different cryptoassets (more than bitcoin)

Crypto-classes

- ▶ Decentralized cryptocurrencies
 - ▶ Bitcoin
- ▶ Semi-centralized cryptocurrencies
 - ▶ Stablecoins
- ▶ Centralized cryptocurrencies
 - ▶ Central bank digital currencies

Applications

- ▶ Smart contracts
 - ▶ Enable blockchains to talk to other technology
- ▶ Decentralized autonomous organizations
 - ▶ Organization governed by smart contracts
- ▶ DeFi
 - ▶ Banking without the banks

Crypto Market Update

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>

Ether staking could trigger securities laws — Gensler

Though he did not specify any particular crypto, SEC chair Gary Gensler said proof-of-stake cryptocurrencies could be subject to securities laws.



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>

U.S. GAAP Primer

- ▶ U.S. Generally Accepted Accounting Principles are the rules that U.S. publicly traded firms must follow
 - ▶ U.S. domiciled and foreign firms trading on U.S. markets
- ▶ Determines how assets, liabilities, and equity instruments are reported on financial statement and for external financial reporting purposes
- ▶ The Financial Accounting Standards Board (FASB) is the group that writes, reviews, and codifies GAAP standards
- ▶ Up until 2021-2022, the FASB refused to consider crypto accounting rules at all

The GAAP problem

- ▶ What is the best way to describe crypto from an accounting perspective?
- ▶ Asset?
- ▶ Liability?
- ▶ Equity?
- ▶ In most cases it can be argued that crypto represents some sort of asset
- ▶ But what kind?
- ▶ Intangible
- ▶ So what's the problem?

The GAAP problem, cont.

- ▶ Under U.S. GAAP
 - ▶ Intangible assets cannot be marked to market
 - ▶ Intangible assets must be tested for impairment
 - ▶ If impairment has occurred, these assets must be written down
 - ▶ After impairment has occurred, the value can never be restored
- ▶ These represent major issues for firms seeking to use/accept/hold cryptoassets
- ▶ Crypto remains a volatile asset class

FASB Takes Action

- ▶ More recently the FASB has taken action to try and resolve these accounting issues
 - ▶ December 2021 the FASB added a digital asset project to its research agenda
 - ▶ May 2022, the FASB added this project to its technical agenda
- ▶ All seemed to be moving in the right direction
- ▶ <https://www.fasb.org/Page/ProjectPage?metadata=fasb-Accounting-for-and-Disclosure-of-Crypto-Assets>
- ▶ Not quite as thorough as was previously hoped

August/September 2022 update

- ▶ The FASB has released a statement setting the criteria that will be used on this project
- ▶ NFTs are excluded
- ▶ Certain stablecoins are excluded
- ▶ No specific crypto named to be included or not



- ▶
- ▶
- ▶
- ▶ <https://www.coindesk.com/business/2022/10/13/fasb-mulls-fair-value-accounting-for-crypto-holdings-report/>



Jarrett vs. United States

- ▶ Nothing has changed as a result of these headlines
- ▶ Staking rewards are still an ambiguous tax topic
 - ▶ Post-merge this will become more important
- ▶ 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>
- ▶ <https://news.bloombergtax.com/tax-insights-and-commentary/taxpayers-in-jarrett-case-still-look-for-an-answer-on-crypto-staking>

Bad news! Sept/Oct 2022

- ▶ Jarrett case has been dismissed
- ▶ Jarrett plans to file appeals with existing legal team
 - ▶ Includes the Proof of Stake Alliance
- ▶ As of right now, block rewards and staking rewards are taxable upon creation
- ▶ <https://news.bloombergtax.com/daily-tax-report/crypto-staking-tax-lawsuit-ruled-moot-after-irs-issued-refund>



Photographer: Michael Shorr/Bloomberg

Crypto Staking Tax Lawsuit Ruled Moot After IRS Issued Refund

Crypto hack - August 2021

- ▶ Over \$600 million stolen in Poly hack
- ▶ Spans multiple blockchains, exchanges, and financial institutions
- ▶ Operates in the decentralized finance (DeFi) space
- ▶ <https://www.reuters.com/technology/defi-platform-poly-network-reports-hacking-loses-estimated-600-million-2021-08-11/>

Technology

Crypto platform Poly Network hacked in estimated \$600 mln cyberheist

Alun John, Tom Westbrook, Tom Wilson



Crypto hack - the plot thickens

- ▶ Most funds were eventually returned..
- ▶ <https://www.reuters.com/technology/over-half-crypto-tokens-stolen-610-mln-hack-now-returned-poly-network-says-2021-08-12/#:~:text=Poly%20Network%2C%20a%20platform%20that,are%20still%20outstanding%2C%20it%20s%20aid.>

Technology

Over half of crypto tokens stolen in \$610 mln hack now returned, Poly Network says

Tom Wilson

Phew...

- ▶ Something you might be thinking is



Accounting Standards?



Nothing authoritative from the FASB that is crypto-specific



AICPA has issued several research and whitepapers



Most recently



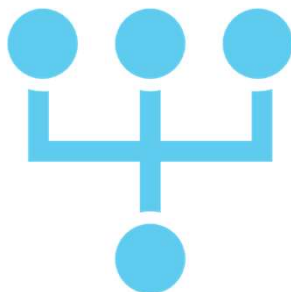
Accounting for and Auditing of Digital Assets [Practice Aid]



<https://www.aicpa.org/interstareas/informationtechnology/resources/blockchain-digital-assets.html>

Blockchain & Audit

Will blockchain destroy the audit?



- ▶ Are auditors going to become redundant?
- ▶ No!
- ▶ Automation is coming to the profession, but blockchain will not replace auditors or the audit process
- ▶ Let's get to it?

Crypto Accounting

Let's
remember



Blockchain is NOT an accounting system



Nothing to do with accounting



It is called a “ledger” but it’s not like ledgers we are used to discussing



More specifics to remember as well

What blockchain doesn't have



No debits



No credits



No income statement



No balance sheet



No cash flows



Blockchain is just a record of transactions at a certain date in time

UTXO model (Bitcoin)



Bitcoin: Unspent transaction output (UTXO) model



How the balance of BTC is tracked



UTXO equals transfer of coins



A transaction spends coins (UTXOs) and creates new coins (UTXOs).



All inputs (UTXOs) must equal all outputs (UTXOs).

Account model (Ethereum)

- ▶ Ethereum: account based balance model.
- ▶ Entire record of the Ethereum is the current state of wallet balances
- ▶ The balance in an account (wallet) is the total number of coins, Ether (ETH).
- ▶ Uses debits (subtracts) and credits (add) to update account balances
- ▶ This is like a journal entry with a debit and credit of the same amount.



ethereum

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▶ Audit Implications

Big picture



- ▶ There are a few things every audit or assurance professional needs to know about blockchain and audit
- ▶ No need to become computer programmers or coding experts overnight
- ▶ Need to be able to articulate and communicate core items that clients and professionals need to know about

Core elements to keep in mind



Every blockchain is different and needs to be monitored individually



Controls will not become less important



Data access and integrity are more important



Audit will need to evolve and change



Clients need to be a part of this conversation

Hard fork vs Soft fork

- ▶ Both a hard fork and soft fork are software upgrades for the underlying blockchain that drives and supports the various cryptocurrencies
- ▶ Hard forks are not backward compatible with previously existing code and cryptocurrencies
- ▶ Soft forks are backwards compatible with existing code and cryptocurrencies
- ▶ Wallets would have to be upgraded

Accounting considerations



If a hard fork occurs, how should the issuance of new currencies be accounting for? (ETH and ETC)



What about soft forks that “edit” the underlying blockchain code?



Are the changes in price that result from forks shown as realized or unrealized gains/losses



What about how these are shown on the P/L and B/S

Food for thought



What if an investor or holder of cryptocurrencies does not want to receive the new versions of the cryptocurrency?



What happens if an investor does not agree with the fork?



Is there a process by which investors can redeem coins prior to the fork?

Audit Implications



Anyone work on a SOC 1 engagement?



What about a SOC 2 engagement?



Section 404 of SOX



What do those have to do with blockchain and cryptoassets?

SOC 1

The SOC 1 report

Also known as the Statement on Standards for Attestation Engagements (SSAE) 18, the SOC 1 report focuses on a service organization's controls that are likely to be relevant to an audit of a user entity's (customer's) financial statements. Control objectives are related to both business process and information technology. A SOC 1 – Type I audit report focuses on a description of a service organization's control and the suitability of how those controls are designed to achieve the control objectives as of a specified date. A SOC 1 –Type II audit report contains the same opinions as a Type I, but it adds an opinion on the operating effectiveness to achieve related control objectives throughout a specified period. Learn more about [SOC 1 Type I and Type II reports](#) here. SOC 1 audit reports are restricted to the management of the services organization, user entities and user auditors.

SOC 2

The SOC 2 report

The SOC 2 report addresses a service organization's controls that relate to operations and compliance, as outlined by the AICPA's Trust Services criteria in relation to availability, security, processing integrity, confidentiality and privacy. A service organization may choose a SOC 2 report that focuses on any one or all five Trust Service principles and may choose either a Type I or a Type II audit. A SOC 2 report includes a detailed description of the service auditor's test of controls and results. The use of this report is generally restricted.

Why was the SOC 2 report created?

The SOC 2 report was created in part because of the rise of cloud computing and business outsourcing of functions to service organizations. These are called user entities in the SOC reports. Liability concerns have caused a demand in assurance of confidentiality and privacy of information processed by the system.

Audit Implications, cont.



- ▶ Core components on blockchain redefine the audit
- ▶ 1) Traceability
- ▶ 2) Transparency
- ▶ 3) Consensus data approval
- ▶ 4) Tamper resistant
 - ▶ Not immutable!
- ▶ 5) Real time nature of data communication

Blockchain impact on audit

- ▶ Generates the following questions:
- ▶ 1) How do we avoid the black box of automation as processes are automated?
- ▶ 2) Are there processes in place to maintain appropriate authorization over the source code?
- ▶ 3) Do we have controls over smart contracts?
 - ▶ Smart contracts are what make blockchains “work” and interact with other technology systems?
- ▶ 4) Blockchain by itself will not verify the accuracy of information

Starting points



Everywhere!



Audits try to attest to

Value
Completeness
Accuracy



Access to network level information can assist with all of these audit functions

Audit considerations



Blockchain will change the workflows associated with internal processes at the both

Client
Audit and accounting firm



Monitoring of data on-ramps and off-ramps will need to increase to accompany the change in data flows

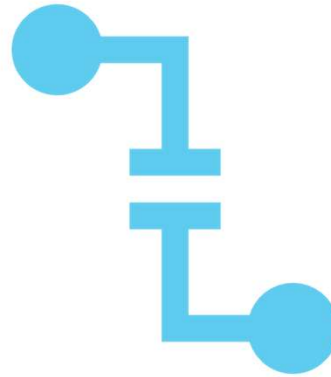


Auditors need to understand how the blockchain is functioning inside the client

And why!

Why controls matter

- ▶ Blockchain and crypto-space is littered with past failures
- ▶ Mt. Gox
- ▶ Quadriga
- ▶ Binance
- ▶ Tether, Crypto Capital, Bitfenex
- ▶ All connected to control and workflow failures
- ▶ Not blockchain problems!



Blockchain use case



Why is the client considering, or implementing, a blockchain platform anyway?



Are there cryptoassets involved, or non-financial data?



Do all involved firms understand the industry specific industry laws that need to be taken into account



Has interoperability been addressed?

Other audit considerations



How is the blockchain updated?



Are employees at the client educated and trained to use blockchain appropriately?



Does the audit team understand how blockchain workflows and the need for controls?



What is the status of GAAS updates and modifications to reflect blockchain-augmented audit?

Blockchain pitfalls



Blockchain is not an accounting system



Augments and supplements accounting systems, but it is NOT an accounting system



Means that interoperability and accuracy of information is still the responsibility of auditors



Controls are even more important in a blockchain environment



Processes do need to change

- ▶ According to an AICPA report, a transaction recorded in a blockchain may:
 - ▶ Be unauthorized, fraudulent, or illegal.
 - ▶ Be executed between related parties.
 - ▶ Be linked to a side agreement that is “off-chain.”
 - ▶ Be incorrectly classified in the financial statements.
- ▶ Represents work opportunities for CPAs
- ▶ <https://www.aicpa.org/content/dam/aicpa/interestareas/frc/assuranceadvisoryservices/downloadabledocuments/blockchain-technology-and-its-potential-impact-on-the-audit-and-assurance-profession.pdf>

Pain points

Where does the auditor fit?



Where exactly does an accounting or audit firm fit in this conversation?



Probably not as a full member

Unnecessary and could compromise independence



Member with limited access



Allowing access to financial data without violating industry specific data privacy laws

New job opportunities

- ▶ **Auditor of smart contracts.** Smart contracts may be embedded in a blockchain to automate business processes. Parties to smart contracts may be eager to engage a CPA to verify that smart contracts are implemented with the correct business logic.
- ▶ **Service auditor of consortium blockchains.** Potential users of private blockchain products may wish to engage a CPA to provide independent assurance on the stability and robustness of the system's architecture. Rather than each participant performing his or her own due diligence, it may be more efficient to hire a CPA to achieve these objectives. A trusted and independent third party may be needed to provide assurance as to the effectiveness of controls over the private blockchain.
- ▶ **Access-granting administrator.** A trusted, independent third-party CPA may be the perfect candidate to serve as the central access-granting administrator for a blockchain that requires permission to join.
- ▶ **Arbitrator.** CPA assurance providers may be among the qualified professionals in the future who would settle disputes among participants in a private blockchain.
- ▶ <https://www.journalofaccountancy.com/news/2018/mar/how-blockchain-might-affect-audit-assurance-201818554.html>

Smart contract auditor

- ▶ Smart contracts are what actually allow blockchains to speak to each other and interact with other blockchains
- ▶ CPAs and auditors can serve as an independent third party to
 - ▶ 1) Check that the code language is up to date
 - ▶ 2) Ensure the smart contracts actually operate as advertised
 - ▶ 3) How is this engagement going to be structured?
 - ▶ 4) How will access to counterparty systems be monitored?
 - ▶ 5) What about internal controls around the smart contract audit?

Service auditor (consortium)



Consortium blockchains seems to be moving to the forefront of enterprise blockchain conversation



Who will help ensure these blockchains are operating as advertised?



Might be simpler to hire a CPA firm to perform an assurance engagement over this?



But, does this impact independence, i.e. who pays the CPA firm?

Access granting role?



Consortium blockchains need different classes of access and authorization



Actually the core value proposition of the consortium model



Who grants, monitors, and updates these levels of access?



CPA firm?



What type of insurance is necessary in this case?

Arbitrator



Who helps resolve problems when they arise?



What if these problems are caused due to

- 1) Outdated blockchain code
- 2) Erroneous smart contract language
- 3) Faulty business logic



All potential opportunities for audit and attestation professionals

Blockchain insurance



Errors and omissions coverage are well understood, but blockchain opens the door for additional insurance liability coverage



Are there even products available out there for clients of accounting firms to purchase?



If so, does the pricing of these policies hinder broader adoption going forward?

Market Examples & ► Resources

EY Blockchain Analyzer



Recently launched Blockchain Analyzer 2.0 tool



To be used for internal clients to date, but portions have been released to the public



High profile example of commercial level application



https://www.ey.com/en_gl/news/2019/04/multimillion-dollar-investment-in-ey-blockchain-analyzer-delivers-new-upgrades-for-blockchain-and-cryptocurrency-audit-and-tax-services

PwC Blockchain Audit Tool



Recently launched and updated



Main point of differentiation is that this tool allows auditors to verify crypto balances and transactions without needing private key information



Critical to custody and provenance



<https://cointelegraph.com/news/will-pwcs-new-software-solve-the-cryptocurrency-auditing-problem>

Microsoft Blockchain



Powered by Azure to audit smart contracts running on the Ethereum blockchain



Remember, smart contracts are what make blockchains do anything



Ethereum forms the basis for most new smart contracts and applications



<https://thenextweb.com/hardfork/2019/06/04/microsoft-azure-blockchain-ethereum/>

Where to learn more



Wall Street Blockchain Alliance



Association of International Certified Professional Accountants (AICPA)



CPA.com



Be sure to look for industry specific resources as well!

Thank you!

- ▶ Questions?
- ▶ Comments?
- ▶ Jokes?
- ▶ Email - drseansteinsmith@gmail.com
- ▶ Twitter - @seansteinsmith
- ▶ LinkedIn - Sean Stein Smith

3:50 – 4:40 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

- Part I - **Hot** Practice and Procedure Issues
- Part II - The Very **Hot** Research Credit, What is New, How to Handle the Audit and Appeal
- Part III - **Hot** Ethics Issues
- Part IV - **Hot** High Net Worth and Family Office Issues
- Part V - **Hot** Employment Tax Issues

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?

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 Procedures¹ 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.

Neutral Revenue Raiser

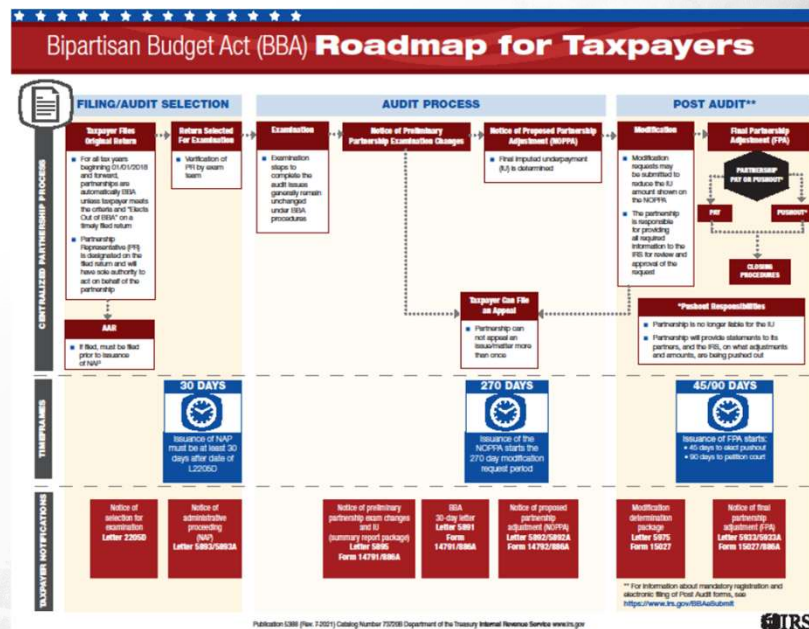
- The BBA was promoted as a “neutral” revenue raiser (*i.e.*, a revenue raiser in disguise); in that an increase in partnership audits will raise revenue without increasing taxes.
- It is expected that the new audit procedures and increased audits will yield \$9.3 billion of additional revenue over ten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

Partnership Audit Road Map

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Current Status

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

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

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

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.

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

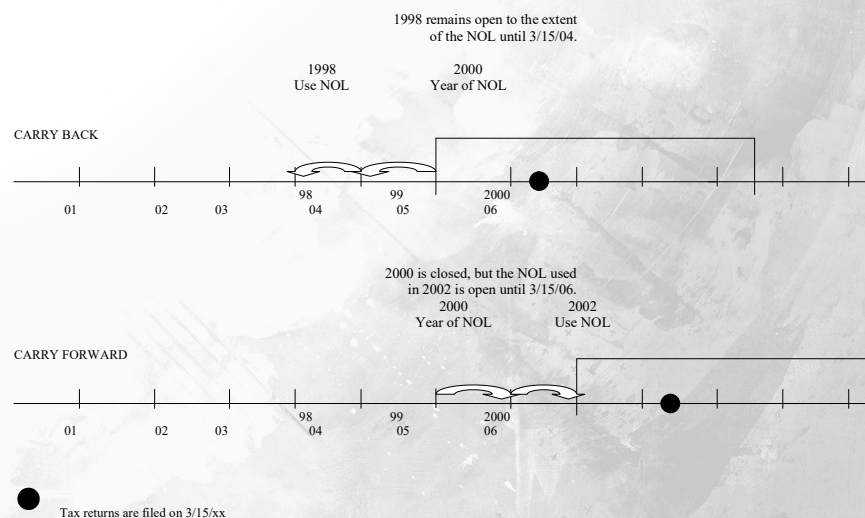
Statute of Limitations Issues (cont.)

- 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)

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

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



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: | | | | | |
| <p>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.</p> <p>a. List all hours and services performed for the 2019 and 2020 calendar years. Provide detailed explanations of services or activities performed.</p> <p>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.</p> <p>Where documents exist in electronic format, please provide in original electronic format.</p> <p>Draft Date: 9/16/2022 Due Date: 11/7/2022</p> | | | | | |
| <p>Information Due By: <u>11/7/22</u> At Next Appointment <input type="checkbox"/> Mail In <input type="checkbox"/></p> <table border="1"> <tr> <td>Name and Title of Requestor: Hwang, Yujin Internal Revenue Agent</td> <td>Badge Number: 1003822997 Phone: 312-292-3152 Fax: 855-330-7359 Email: Yujin.hwang@irs.gov</td> <td>Date: 9/16/2022</td> </tr> </table> <p>FROM: Office Location: Internal Revenue Service; Mail Stop 4171 LB&L/ECPA/1113; 230 S. Dearborn; Chicago, IL 60604</p> <p>Form 4564</p> | | | 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 |
| 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 | | | |

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Passive Losses and the Real Estate Professional

- 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

Examples

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

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.

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

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

The IRS Tour

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

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?

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**).

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 or 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"

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)

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

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)

Acknowledgement IDR

- Use the acknowledgement IDR to support your case

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| Form 4564 (Rev. September 2008) | | Department of the Treasury — Internal Revenue Service Information Document Request | | Request Number AOF-1 |
|--|---|--|---------------------------------|-------------------------|
| Name of Taxpayer and Company Division or Branch [Redacted] | | Subject Acknowledgment of Facts [Redacted] | | |
| Please return Part 2 with listed documents to requester identified below | | Date of Previous Request [Redacted] | | |
| <p>Description of documents requested</p> <p>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.</p> <p>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 L&SI 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 L&SI can make an accurate tax determination. While the interpretation of the law or the amount of the proposed adjustment may be disagreed, all relevant facts should be included in the attached draft Form 886-A.</p> <p>Requested items</p> <p>Your response to the facts does not indicate agreement to the issue or any proposed tax adjustment</p> <p>1. Please review the attached draft Form 886-A and respond accordingly in writing to the L&SI 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.</p> | | | | |
| Information Due By: 01/11/2019 At Next Appointment <input checked="" type="checkbox"/> Mail in <input type="checkbox"/> | | | | |
| From: | Name and Title of Requester [Redacted] | Employee ID number [Redacted] | Date (mm/dd/yyyy) [Redacted] | |
| | Office Location [Redacted] | Telephone Number [Redacted] | | |
| Getting Number 331485 www.irs.gov Part 1 - Taxpayer's File Copy Form 4564 (Rev. 9-2008) | | | | |

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| | | |
|---|--|-------------------------|
| Form 4564 (Rev. September 2005) | Department of the Treasury — Internal Revenue Service Information Document Request | Request Number ACF-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 <input checked="" type="checkbox"/> | Mail In <input type="checkbox"/> |
| Name and Title | Requestor | Employee ID number | Date (month/year) |
| Internal Revenue Agent | | | |
| From: | Office Location | Telephone Number | |
| | | | |

Catalog Number 22140K www.irs.gov Part 1 - Taxpayer's File Copy Form 4564 (Rev. 9-2005)

| | | |
|-------------------|---------------------------|---------------|
| Form 886-A | Explanation of Items | Page 1 of 9 |
| Name of Taxpayer | Tax Identification Number | Issue No. |
| | | 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 | \$ [REDACTED] | \$ [REDACTED] |
| 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 | Explanation of Items | Page 2 of 9 |
| Name of Taxpayer | Tax Identification Number | Issue No. |
| | | 201612-201712 |

Facts

was founded in designs and manufactures

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, prepared the returns, conducted a Research Credit study and aided in the credit computations.

On September 21, 2018, provided a tour of their facility WI to gain a better understanding of its operations and the extent of research conducted. In addition, we interviewed 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.

does not track QREs by project, instead determines qualified wages on an employee-by-employee basis. 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

| | 2013 | 2014 | 2015 | 2016 | 2017 |
|-------------------|------|------|------|------|------|
| Wages | | | | | |
| Supplies | | | | | |
| Contract Research | | | | | |
| Total QREs | | | | | |

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

| | | |
|------------------|---------------------------|---------------|
| Form 886-A | Explanation of Items | Page 1 of 9 |
| Name of Taxpayer | Tax Identification Number | Issue No. |
| | | 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

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

| Form 886-A | Explanation of Items | Page 4 of 5 |
|------------------|---------------------------|------------------------------------|
| Name of Taxpayer | Tax Identification Number | Issue No. |
| | | 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)(i), 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.

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

| Form 886-A | Explanation of Items | Page 5 of 5 |
|------------------|---------------------------|------------------------------------|
| Name of Taxpayer | Tax Identification Number | Issue No. |
| | | 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)(i). 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 in 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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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 96% 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,

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

| | | |
|------------------|---------------------------|---------------------------------------|
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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] to 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.

| | | |
|--------------------------------|---|---|
| Form 886-A | Explanation of Items | Page 9 of 9 |
| Name of Taxpayer [REDACTED] | Tax Identification Number [REDACTED] | Issue No. Year/Period Ended 2016/12-2017/12 |

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 |
|-----------------------|---------------|---------------|
| Credits per Return | \$ [REDACTED] | \$ [REDACTED] |
| per IRS Audit | \$ [REDACTED] | \$ [REDACTED] |
| Adjustments to Credit | \$ [REDACTED] | \$ [REDACTED] |

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 statute or refuse to extend, docket the case in Tax Court and then go to Appeals

Getting to Appeals

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

Settling the Case at Appeals

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

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

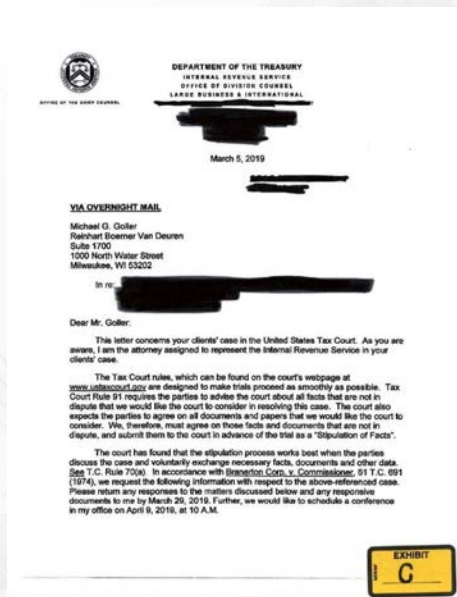
The Current IRS Litigation Position

- 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

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

Research Credit Branerton Letter



TL-20815-18

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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;

- 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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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;

- 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;

- 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/logs 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;

- 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 ██████ generally during the relevant tax years;
18. For each business component for which Petitioners claim ██████ incurred qualified research expenses, please provide all documents supporting the amounts paid or incurred by ██████ or 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 ██████ in which the ██████ had qualified research expenses pursuant to I.R.C. § 41.
- 20. Please identify the first taxable year in which ██████ had gross receipts.
- 21. Please identify all taxable years in which ██████ had both gross receipts and qualified research expenses pursuant to I.R.C. § 41.
- 22. Please identify the gross receipts of ██████ 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:

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 ██████

Sincerely,

████████████████████

Attorney

(Large Business & International)

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**

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).

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)

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.**

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

| | <u>Reasonable Basis</u> §1.6662-3(b)(3) | <u>Reasonable Cause</u> §6664 §1.6664-4(b) | <u>Disclosure</u> §6662(d)(2)(B) §1.6662-3(a) | <u>Substantial Authority</u> §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)(iii).

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 is 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, there is always an S.U., even if \$10,000 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

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.”

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)

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

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

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

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

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

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*

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).

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)

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

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.

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.

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

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

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)

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

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.)

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.

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

Other Authority

- ACTEC Commentary to Model Rule 1.7

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

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.

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

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?

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.

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)?

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.

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.

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.

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.

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)

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

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

Intake

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

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

Obligations of the CPA Firm If There Is a Data Breach

- CPA Firms Need to Collect Data
- Tax
- 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"

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"

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

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

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

Need both a PTIN and a Data Security Plan



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](#)
- [Back to top](#)

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](#)

[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

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;

Section 10.36

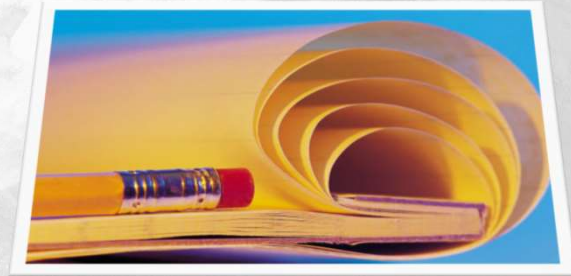
- 2(a) The responsible practitioner, through willfulness, recklessness or gross incompetence, does not take reasonable steps to ensure that firm procedures in effect are properly followed; and
- 2(b) One or more individuals who are members of, associate with, or are employed by the firm or have engaged in a pattern or practice, in connection with their practice with the firm of failing to comply with Circular 230; or

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.

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

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

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

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).

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

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

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

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.

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.

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)

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

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 ...”

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.

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

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

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

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

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)

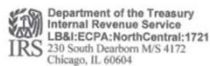
High Net Worth Issues (cont.)

- 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

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**



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

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.irs/ideos.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,

[Signature]
[redacted]
Internal Revenue Agent

Enclosures:
Publication 1
Notice 609

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

Reinhart
Boomer Van Deuren & Co. Attorneys at Law

| | | |
|-----------|--|-----------------------|
| 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 worth 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 <input type="checkbox"/> Mail In <input type="checkbox"/> | | |
| 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:III3; 230 S. Dearborn; Chicago, IL 60604 | | |

Form 4564

Page 1 of 3

| | | |
|-----------|--|-----------------------|
| 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 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 worksheets 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 [redacted] and its disregarded entity/entities (flowing into Form 1040) for tax year ending December 31, 2019. Provide any Schedule K-1 worksheets and reconciliation to the 2019 tax return.

| | | |
|---|---|--------------------|
| Information Due By: 11/05/21 At Next Appointment <input type="checkbox"/> Mail In <input type="checkbox"/> | | |
| 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:III3; 230 S. Dearborn; Chicago, IL 60604 | | |

Form 4564

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| | | |
|----------------|--|-----------------------|
| Form 4564 | Department of the Treasury Internal Revenue Service Information Document Request | Request Number 001 |
| To: [REDACTED] | 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, 1098, 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 | <input type="checkbox"/> | Mail To: <input type="checkbox"/> |
| Name of Requestor: | Badge I | Date: 10/8/2021 | |
| Internal Revenue Agent | Plus | | |
| | Fax: | | |
| | Email: | | |
| FROM: Office Location: | | | |
| Internal Revenue Service; Mail Stop 4171 | | | |
| LB&L/ECPA-1113; 230 S. Dearborn; Chicago, IL 60604 | | | |

Form 4564

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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.

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.

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

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.

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.

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"

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.

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.

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.

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).

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 may 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.

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)

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)

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 Understatement²
 - Gross Valuation Misstatement (income tax)³
 - Gross Estate or Gift Tax Valuation Understatement⁴

-
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.

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)

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

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Reasonable Cause

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

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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.

CONCLUSION