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IMPACT

Issue 113

A Review of Potential Risks Associated with the Tax Cuts and Jobs Act ("TCJA") —

Highlights of areas likely to generate errors and claims, including planning considerations and other key risk management points

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A Review of Potential Risks Associated with the Tax Cuts and Jobs Act ("TCJA")

by Arthur V. Pearson, J.D., L.L.M.

It goes without saying that the Tax Cuts and Jobs Act ("TCJA"), which passed into law on December 22, 2017 (Pub. L. 115–97), was a sea change in the Internal Revenue Code. It benefitted many taxpayers, disadvantaged many others, and handed tax professionals a steep learning curve to become proficient with its provisions.

This article is not intended to be a technical review of the TCJA, although we will touch on some technical points. Rather, it highlights what we see as areas that seem likely to generate errors and, in turn, claims against tax professionals. Our goal is to sharpen our scan when working in these areas so we minimize our risk in what will be an inherently uncertain endeavor for a few years.

We have also highlighted **"Planning Considerations" and other key points in boldface** in the following text to assist tax professionals and their clients in the planning process and management of risk.

More Fees Due to Complexity

While not a matter of substantive tax law, the fees we bill to our clients for tax planning and consulting are likely to be higher this year than in the past, and that may create some tension with clients. These additional fees to advise and assist them in TCJA compliance may be unavoidable for many clients, and those who are fee-averse to begin with could be especially unhappy. We are of course expected to know the tax law as changed by the TCJA, but in applying it to individual clients it will be, for many, a case of first impression. That requires some thought and some time. If we try to work with one eye on the clock, it can lead to errors.

Planning Considerations

As a first step, we should inform our clients who may require additional planning and consulting related to TCJA of the likelihood of higher fees for 2018, and perhaps for a while thereafter, and why higher fees may be necessary. This information can accompany the annual tax questionnaire — a good place to start. The point can be followed up at the next opportunity to communicate with the client. Engagement letters should be used now more than ever for all tax clients to clarify terms and conditions of the services to be performed, and the fees associated with the services being rendered.

Alimony

Alimony comes from an unhappy place called divorce. The new alimony rules won't make divorcing couples any happier. As we know, **alimony payments required under divorce or separation instruments that are executed after December 31, 2018, are not deductible under the new law.** Recipients of affected alimony payments will no longer have to include them in taxable income. Clients who are in divorce proceedings and want deductible alimony treatment for some or all of the payments that will be made to the other party must get their divorce agreement completed and signed by December 31, 2018. However, the recipients of those payments have a big incentive to put off finalizing the agreement until after 2018 because the payments would be tax-free to the recipient. Thus, there is significant risk from involvement with clients who fail to formalize their divorce/separation before the December 31, 2018, deadline. The damages could be substantial.

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That divergence of interests between the people getting the divorce is yet another conflict of interest "red flag" in the collection of "red flags" related to doing work for divorcing couples. Don't count on conflict waivers to save the day. We should also not count on divorce attorneys to know the ins and outs and intricacies of the new tax law as it applies to divorce — even though they should. So, if we have clients who have announced a divorce, we have a choice to stay engaged or disengage; if we stay engaged, we must be mindful of the risk, have signed conflict of interest waivers in place, and try to control events that involve us.

IRC §199A

The TCJA enacted IRC §199A, which made individuals, trusts, and estates eligible for a 20% deduction from their allocable domestic qualified business income (QBI) from each partnership, as well as LLCs, S Corporations, sole proprietorships, disregarded entities, real estate investment trusts (REITs), qualifying cooperatives, and qualifying publicly traded partnerships. In other words, a wide swath of our clients may be able to benefit from the provisions of §199A.

This new deduction is unfortunately complicated, and based on prior tax law changes it will take some time before the IRS can issue meaningful guidance. However, client pressure to exploit the planning opportunities is likely, and tax professionals will be asked how they can reduce their clients' tax burdens through creative strategies centered around the QBI deduction. This dynamic may lead to planning based on judgment, guesswork, and tax instincts.

To begin with, there are definition issues and limitations that make §199A a complex law to apply:

Income from many service businesses may not qualify. There is an adjusted gross income (AGI) threshold below which the taxpayer can be exempted from this, and another above which the deduction phases out.

Section 199A impacts cooperatives, REITS, publicly traded partnerships, and their related dividends and distributions, and creates planning issues. For instance, farmers may find it beneficial to form cooperatives but may not know of the benefits or if the opportunity applies to their situation unless their tax professional mentions it.

There are limitations on the amount of the deduction based on the level of W-2 wages and tangible depreciable property in the business; however, this is not applicable below certain AGI thresholds.

Planning Considerations

A sampling of the planning issues we may confront, and this is hardly an exclusive list, includes:

- **Reducing income to stay below income thresholds**
- **"Changing" specified service income into non-specified service income**
- **Changing salaried employees to independent contractors**
- **Changing independent contractors to salaried employees**
- **Getting out of C Corporation entities**
- **Increasing wages (adding payroll tax expense) to gain more of QBI deduction**
- **If the client owns multiple businesses, exactly what is meant by qualified business income, is it aggregated, or should be it be?**

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- **If the client operates several businesses out of the same entity, should they be redeployed to other entities?**
- **Is the 21% C Corporation rate better than the available QBI deduction?**

The main point here is not so much the specific planning issues, but that there will be many planning issues, and addressing the changes wrought by §199A will require more than rote application to our clients' situations. In addition, the client may also need to engage other professionals to address the legal implications associated with some of these planning opportunities. For example, the decision to change salaried employees to independent contractors and vice versa will require the guidance and expertise of an Employment Practice attorney with expertise in this area. Addressing the multitude of planning opportunities for a client will take time, effort and the involvement of the client in the process. Consequently, tax planning engagements will have unique terms and conditions, including additional client fees for such services, which should be covered in a separate engagement letter. Refer to CAMICO's sample engagement letter, titled "Tax Reform: Business Income Tax Planning," which is available for download from the Members-Only Site on the Knowledge Tree under CAMICO Publications → IMPACT → 2018 → IMPACT 113 or from the Engagement Letter Resource Center under "Other Tax Letters" in the Tax Letters section.

Global Intangible Low Tax Income (GILTI)

The TCJA adds IRC §951A effective for taxable years of foreign corporations beginning after December 31, 2017. It provides that a U.S. shareholder of a controlled foreign corporation (CFC) must currently include a certain type of income called Global Intangible Low Tax Income (GILTI) whether or not distributions are received. GILTI is for some taxpayers[1] subject to a 50% deduction resulting in a base rate on GILTI of 10.5%.

The perceived risks here are that this new law has many unanswered questions in its application and raises risks on tax advice or its omission.

The GILTI calculation itself is challenging and primed for errors. Also, questions remain on how it is applied. Among the many questions about the application of GILTI are whether GILTI losses, income, and foreign tax credits can or cannot be netted, and whether GILTI will be calculated at the U.S. shareholder level, or jointly among a consolidated group or sub-group.

Another risk is tax advice given or omitted on how a given business structure may incur higher tax rates. The GILTI rules apply a higher tax rate (37%) to GILTI attributed to individuals and trusts who own Controlled Foreign Corporation (CFC) stock directly or indirectly through LLCs or S Corporations as compared to C Corporation shareholders.

Planning Considerations

This is where tax advice risk exists. Clients who own shares in a CFC either directly or through a LLC or S Corporation expose themselves to a higher tax rate than if they held those same shares through a C

[1] The 10.5% GILTI tax rate only applies to international businesses that **do not** engage in U.S. trade or business.

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Corporation. Of course, getting the income out of the C Corporation may be a taxable dividend. The tax planner may also have to consider a §962 election.[2]

Also, because the effective GILTI tax rate is half of the domestic corporate income tax rate, corporate taxpayers could reduce overall tax by reporting losses in the U.S. and accepting the 10.5% GILTI rate on overseas income.

CFCs have been frequent flyers in the claims arena. The GILTI overlay on the CFC's rules won't decrease complexity of the risk to tax professionals who have clients with CFCs. This is clearly a "heads up" area.

Interest Limitations

The newly amended §163(j) of the Tax Code provides the ability to deduct interest expense paid or accrued for many businesses — not just corporations. **Business interest deductions generally will not be permitted to the extent net interest expense exceeds an adjusted earnings–based threshold.** The limitation on interest deductions may result in an increased tax liability to corporations and investors in flow-through businesses that finance acquisitions with debt such as, for example, businesses that have undergone private equity–sponsored leveraged buy-outs (LBOs) or similar transactions.

Planning Considerations

CPAs and business clients planning transactions involving debt may be unaware of the new limitations on interest deductions. If we actively through an error or inadvertently through passivity don't correct this lack of awareness and out-of-date belief, our clients may look to us if they get a tax surprise after the transaction is done.

Net Operating Loss Changes

The law prior to the TCJA, generally, required net operating losses (NOLs) to be carried back two tax years, with the remaining NOL carried ahead to the 20 succeeding tax years, after which it expired. For regular tax purposes, the NOL was eligible to offset up to 100% of taxable income of a tax year (90% for Alternative Minimum Tax purposes) within the carryback and carryforward periods.

For NOLs arising in tax years beginning after December 31, 2017, the TCJA limits the NOL deduction to 80% of taxable income and eliminated the two-year carryback period but now provides an indefinite carryforward. For NOLs generated in tax years ending on or prior to December 31, 2017, prior tax law still applies — the 80% limitation on NOLs won't apply, and the NOLs can be carried forward 20 years.

The legislation makes NOLs less valuable than they were in the past, which could require tax plans made prior to the TCJA to be re-examined if the use of NOLs was a material part of the plan.

Seeing that adequate records exist to classify NOLs as pre- or post-December 31, 2017, may fall on tax professionals, which makes it a risk. That also means educating clients and perhaps having an independent means of breaking the data out.

Limitations of Itemized Deductions

The TCJA law gave a substantial increase to the standard deduction, but it took away or limited many common itemized deductions. **Starting with 2018, individuals are permitted to deduct up to $10,000 ($5,000 married filing separately) in state and local taxes (SALT). In states that have high real property**

[2] Making a §962 election permits an individual to be taxed as a corporation, lowering the tax rate to 21%, not to 10.5%.

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taxes or high income taxes or both, these limits will make many taxpayers face higher federal tax bills, and in some instances, substantially higher.

There are risks here. Several states have proposed passing laws that would allow taxpayers to make a contribution to a state charity and for which they would receive up to a dollar-for-dollar credit against their state tax obligation. The taxpayer could then deduct the "contribution" as a charitable gift on the federal return. There have also been some published tax plans for getting around the SALT deduction limits using LLCs and Alaska trusts to own portions of one's home. Whatever the plan may be, tax professionals know that this is a controversial area.

The IRS hasn't been asleep on the charitable deductions/state tax credit issue and has issued Proposed Regulations for IRC §170 (I.R. 2018-172), which rejects the state charitable deduction/state tax credit plan. However that fight turns out, which may be many years in the future, tax professionals are dealing with the immediate issue of clients' requests to use these devices to get around the TCJA limits. Proposed Regulations are of course just the Service's "position." They aren't yet law, but they are a pretty good indication that action taken in contravention of that "position" will likely elicit a fight.

If your client wants to take a position that appears to be contrary to a "position" of the IRS, assuming professional standards are met (AICPA Statement on Standards for Tax Services (SSTS) and IRS Circular 230), steps should be taken to make the client, rather than you, responsible for the consequences. DOCUMENT, DOCUMENT, DOCUMENT!

Commercial Real Estate Depreciation

One of the winners in the TCJA was commercial real estate. Qualifying property placed in service after September 27, 2017, is eligible for 100% bonus depreciation, which drops 20% a year starting in 2023 and is gone by 2027. Used property[3] is now able to be completely expensed.

The TCJA also changed IRC §179 by increasing the annual §179 limitation from $500,000 to $1 million, with a phase-out beginning at $2.5 million for qualifying assets placed in service. IRC §179 property now includes fire protection systems, alarm systems, security systems, HVAC, and roof structure.

Planning Considerations

Tax professionals who have clients with commercial real estate will need to address the changes. TCJA limited business interest deductions, and some businesses may not want to maximize depreciation deductions in order to preserve more of the interest deduction. Also, cost segregation studies may become more useful. There will be planning challenges here.

Estate and Trust Limitations on Miscellaneous Itemized Deductions

The TCJA included IRC §67(g), which disallows itemized miscellaneous deductions exceeding the 2% floor. Estates and non-grantor trusts calculate their adjusted gross income the same way as do individuals and thus would seem subject to the same §67(g) limitation.

The IRS issued Notice 2018-61, which confirms that §67(e) expenses remain deductible in determining the adjusted gross income of a non-grantor trust or estate during the taxable years to which §67(g)

[3] Eligible assets are those with a depreciable life of 20 years or less — personal property and "qualified improvement property," which is defined as work done to the interior of a commercial building, excluding costs related to the enlargement of a building, an elevator or escalator, or the internal framework of the building.

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applies. The Notice also addresses if a beneficiary may deduct §67(e) expenses on the termination of a non-grantor trust or estate pursuant to IRC §642(h)(2). The Notice announces that Regulations will be issued to bring clarity to this area.

Conclusion

The changes in the body of tax law generated by the TCJA will, like tax law changes in the past, take a long time to digest, as we clarify the ambiguities, coverage gaps, and questions that always follow new law. Tax professionals have clients who want answers now. That dichotomy can put pressure on us to provide advice that may be based more on experience and intuition than on clear authoritative guidance. In such situations, applying **appropriate risk management techniques** will be critical to minimize exposure on the CPA.

Appropriate risk management includes at a minimum keeping the client part of the process to manage expectations. CAMICO's claims experience continues to show that CPAs who successfully manage client expectations, which includes informing clients of opportunities and advising clients of risks, in addition to just following professional standards, are more likely to "get it right" and avoid becoming victims of potential liability exposures.

And of course, DOCUMENT, DOCUMENT, DOCUMENT!

By highlighting some areas in TCJA for which we should sharpen our scan, we can better manage and reduce our risk of an engagement failure.

————————————————————

Arthur V. Pearson, J.D., L.L.M., is a principal of the law firm of Murphy, Pearson, Bradley & Feeney, which has offices in San Francisco, Sacramento and Los Angeles. Art has worked with CAMICO policyholders for more than 25 years and can be reached at: apearson@mpbf.com.

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Tax Reform: Business Income Tax Planning Engagement Letter

<Date>

<Client Representative>
<Client Name>
<Client Address>

Dear <Client Representative>:

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide. Please read this letter carefully, as it is important to both <Firm Name> and <Client Name> that you understand and accept the terms under which we have agreed to perform our services.

Tax Planning[1]
You have asked our firm to assist your company with your tax planning needs given the changes that may impact <Client Name> related to *The Tax Cuts and Jobs Act* ("Tax Act").

Given the magnitude of the changes the Tax Act contains, as well as some new concepts introduced in the law, additional stated guidance from the Internal Revenue Service, and possibly from Congress in the form of technical corrections, may be forthcoming. We will use our professional judgment and expertise to assist you with evaluating the company's 2018 tax planning strategies given the Tax Act guidance as currently promulgated. We will also address with you any state conformity issues currently identified that may impact the company's particular tax situation.

If requested as part of the tax planning engagement, we will provide you with income tax projections for the business that may include potential tax planning strategies. Our goal is to help management identify opportunities that may be available to help minimize the tax liability. Management is free to follow or to disregard, in whole or in part, any tax planning strategies and recommendations we may make. It is our policy to put all advice and recommendations upon which a client intends to rely in writing. We believe this is necessary to avoid any confusion and make clear the specific nature of our advice. Management should not rely on any unwritten advice from our firm.

In performing our services, we require management's cooperation in providing various types of information and documents concerning the company's financial and tax situation. The appropriateness of our recommendations depends on the reliability of the information management provides to us. We will not audit or otherwise verify the data submitted by management or its representatives that is used in our calculations and planning; however, we may ask for additional clarification of some information.

The tax planning, projections and advice we offer reflect our professional judgment based on the facts provided to us and the tax reform changes as currently stipulated by the Tax Act. Subsequent developments changing the facts provided to us, or differences in the final regulations once they are issued by the applicable tax authorities, may affect the advice previously provided. These effects may be material.

We are not attorneys, and nor are we registered investment advisors; therefore, we will not give any legal or

[1] CAMICO strongly encourages firms to tailor this section for the specific scope of their tax planning engagement.

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investment advice as part of this engagement. At your written request, we will participate in discussions with any professional advisors of your choosing (e.g., attorney, investment broker, etc.) regarding tax planning advice or recommendations.

Our services are designed to supplement management's own tax planning and they are not meant to mitigate the necessity of ongoing review. If we are engaged to assist in the implementation procedures of the advice offered, we will continue to advise you of any changes as warranted by new developments from tax authorities; otherwise, we cannot be held responsible for changes occurring between the time we offer advice and the time you implement it.

As our engagement is limited in nature, our services will not include the preparation of tax returns or other tax filings that you may be obligated to submit to the taxing authorities or other governmental agencies. If you would like to retain our services for the preparation of tax returns and/or other required filings, we will cover the terms and conditions of those services under a separate engagement letter(s).

Management Responsibilities

[*For attest clients include the following language in your engagement letter:* By your signature below, you acknowledge that you are responsible for management decisions and functions. That responsibility includes designating a qualified individual, preferably within senior management, with suitable skills, knowledge and/or experience to be responsible and accountable for overseeing all the specific services we perform as part of this engagement, as well as evaluating the adequacy and results of the services performed. You are responsible for establishing and maintaining internal controls, including monitoring ongoing activities.]

Management is responsible for, and shall make, all decisions in connection with the tax planning services provided under this agreement. This responsibility includes making the final decision regarding implementation of a tax planning strategy and/or recommendation.

In addition, management is responsible for providing us with access to all information of which management is aware that is relevant to the tax planning process, such as records, documentation, and other matters, as well as additional information we may request for this engagement. You understand and acknowledge that management is responsible for the accuracy and completeness of the records, documents, explanations, and other information provided to us, including management's significant judgments and assumptions impacting the 2018 tax year.

By your signature below, you acknowledge that management recognizes the inherent limitations of this engagement as there may be subsequent developments issued by the applicable tax authorities that may affect the information we have previously provided, and/or changes to the facts management has provided to us. The effects of such changes may be material.

Our engagement cannot be relied upon to disclose errors, fraudulent reporting, misappropriation of assets, or illegal acts that may have occurred. By your signature below, you acknowledge and agree that management is responsible for preventing and detecting fraud.

Other Matters

In accordance with the terms and conditions of this agreement, <Client Name> shall be responsible for the accuracy and completeness of all data, information and representations, including significant assumptions, provided to us for purposes of this engagement. Because of the importance of oral and written management representations to the effective performance of our services, <Client Name> releases and indemnifies our firm

and its personnel from any and all claims, liabilities, costs and expenses attributable to any misrepresentation by management and its representatives.

Our fees for this work will be at our regular hourly rates for the individuals involved plus out-of-pocket expenses. Payment for services is due when rendered and interim billings may be submitted as work progresses and expenses are incurred. Billings become delinquent if not paid within <number> days of the invoice date. If billings are past due in excess of <number> days, at our election, we may stop all work until your account is brought current or withdraw from this engagement. <Client Name> acknowledges and agrees that we are not required to continue work in the event of <Client Name>'s failure to pay on a timely basis for services rendered as required by this engagement letter. <Client Name> further acknowledges and agrees that in the event we stop work or withdraw from this engagement as a result of <Client Name>'s failure to pay on a timely basis for services rendered as required by this engagement letter, we shall not be liable for any damages that occur as a result of our ceasing to render services.

It is our policy to keep records related to this engagement for <number> years. However, <Firm Name> does not keep any original client records, so we will return those to you at the completion of the services rendered under this engagement. When records are returned to you, it is your responsibility to retain and protect your records for possible future use, including potential examination by any government or regulatory agencies.

By your signature below, you acknowledge and agree that upon the expiration of the <number>-year period, <Firm Name> shall be free to destroy our records related to this engagement.

If any dispute arises among the parties hereto, the parties agree to first try in good faith to settle the dispute by mediation administered by the <Name of Association> under its applicable rules for resolving professional accounting and related services disputes before resorting to litigation. The costs of any mediation proceeding shall be shared equally by all parties.

Client and accountant both agree that any dispute over fees charged by the accountant to the client will be submitted for resolution by arbitration in accordance with the applicable rules for resolving professional accounting and related services disputes of the <Name of Association>, except that under all circumstances the arbitrator must follow the laws of <Name of State>. Such arbitration shall be binding and final. IN AGREEING TO ARBITRATION, WE BOTH ACKNOWLEDGE THAT IN THE EVENT OF A DISPUTE OVER FEES CHARGED BY THE ACCOUNTANT, EACH OF US IS GIVING UP THE RIGHT TO HAVE THE DISPUTE DECIDED IN A COURT OF LAW BEFORE A JUDGE OR JURY AND INSTEAD WE ARE ACCEPTING THE USE OF ARBITRATION FOR RESOLUTION. The prevailing party shall be entitled to an award of reasonable attorneys' fees and costs incurred in connection with the arbitration of the dispute in an amount to be determined by the arbitrator.

We shall be pleased to discuss this letter with you at any time. If the foregoing is in accordance with your understanding, please sign the copy of this letter and return it to us.

Sincerely,

____

<Accountant Name>
<Firm Name>

The above letter sets forth my understanding of the terms and objectives of the engagement to provide tax

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planning services.

AGREED AND ACCEPTED:

____
<Client Representative>
<Client Name>

____
Date

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Documentation Tips for Tax Season

With the increasing complexities in tax law and regulations facing CPAs today in light of the Tax Cuts and Jobs Act ("Tax Act," "Act" or "TCJA"), which introduced the most significant changes to the U.S. tax system since 1986, it is even more difficult to stay current on risk management and loss prevention practices.

As showcased in CAMICO's lead article titled, "A Review of Potential Risks Associated with the Tax Cuts and Jobs Act ("TCJA")", written by Art Pearson, J.D., L.L.M., tax practitioners are faced with the burden of how to address with their clients the implications of tax reform without putting themselves, or their firms, at risk. Good **documentation** is critical to successfully managing client expectations. Jurors (who are just members of the public) generally consider CPAs to be experts in documentation, and falling short of that expectation when faced with a liability suit may be viewed by the public as negligent and below the standard of care for the services rendered.

The following are some documentation tips to follow for tax season:

- **Always document significant meetings, communications and follow-up.** Follow up with written communication in the following circumstances, such as:
  - Change in the scope of an engagement (may require a new engagement letter)
  - Negative information (e.g., tax return is already late, client's failure to timely provide information, client is facing an audit)
  - Judgment calls (e.g., the former CPA took an aggressive position that client is aware of and has consented to)
  - Client needs to take material action on discussion
  - Conversations regarding transactions or amounts used for extension payments

- **Obtain written confirmation of the amounts used for calculations.** For example, a confirmation can be sent to the client with the tax extension payment form, giving the client an opportunity to review the information and to change any information that appears incorrect, prior to April 15. The confirmation then serves as a record of the client's representations in case the client incurs a late payment penalty.

- **If you need information at the last minute** to complete a return, have the client send the data via email or fax. The email or fax becomes part of your records, support and documentation. Remind the client that their return may need to be extended if they fail to cooperate with the request.

- **Use informed consent letters** in engagements such as S Corporation elections or conversions, estate tax planning, and aggressive or gray tax strategies, clarifying that the CPA advises and informs, while the client decides. With this letter, it is difficult for claimants to make it appear that the CPA made the decisions and is responsible for the results.

- **Aggressive or gray tax positions** may call for the client to provide you with an opinion from tax counsel confirming that the position has a realistic possibility of being sustained on its merits if challenged. If you're advising a client on a complex transaction or exchange, you may want to have your legal counsel review the documentation before passing it on to your client.

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- **Documentation should be factual, professional, and without personal comments,** which may be inappropriate and damaging to the integrity of the documentation. Ask yourself whether you or your client would be harmed if the documentation was presented to the "ladies and gentlemen of the jury."

More documentation guidance and tips can be found on the CAMICO Members-Only Site under **Knowledge Tree —> Risk Management —> Documentation Issues.**

Remember, be proactive, not reactive, as you work with your clients this tax season. It is important to recognize that you may have some clients that are no longer the "right fit" for your firm; disengaging from those clients may be in everyone's best interests in the long run.

Policyholders can always contact the CAMICO Loss Prevention department for more risk management advice and guidance as you navigate the challenges of this upcoming tax season. Call 1.800.652.1772, or email lp@camico.com.

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The Wayfair Decision — Additional Sales Tax Collection and Reporting for Out-of-State Sales May Be Required

The Supreme Court's decision in South Dakota v. Wayfair, Inc. ("Wayfair") gives rise to a new era and enhanced complexities with respect to sales tax compliance. In this June 2018 landmark case, the Supreme Court ruled that states can require remote sellers to collect and remit the applicable sales or use tax on sales delivered to locations within their state, regardless of whether the seller has a physical presence in the state. The Wayfair decision clearly undermines decades of precedent with prior state tax cases that supported and required a "physical presence" standard.

The full implications of this ruling are not fully understood, but it is clear that it will likely impact more than just large Internet retailers; implications will be felt by small businesses, entrepreneurs, and consumers, as well.

Generally, states that impose sales tax require sellers with "sufficient contact" for purpose of "sales tax nexus" with the state to collect and remit state and local sales tax on remote sales. At the heart of the Wayfair decision is a redefinition of what is deemed to be "sufficient contact" for purposes of sales tax nexus. Prior to the Wayfair decision, sellers were required to have a physical presence (property and/or payroll) in the state before the duty to collect and remit sales tax could apply. The physical presence requirement was affirmed back in 1992 by the Supreme Court in Quill Corp. v. North Dakota ("Quill"). While Quill was the law until June 2018, over the years, several states enacted laws that further expand what constitutes physical presence.

States that impose a sales tax invariably impose a corresponding use tax that is imposed on consumers in cases where the seller has not collected sales tax. Although Internet purchases are not exempt from sales tax, remote sellers often do not have physical presence in most of the states in which they have sales and were not required to collect and remit the tax in those states. Coupled with the fact that consumers often do not remit use tax to their state of residence for out-of-state purchases, remote sellers enjoyed a competitive edge over sellers required to collect and remit sales tax.

The Wayfair decision recognized the fact that states do not receive sales/use tax from many Internet-based sales and found the physical presence requirement unworkable. Thus, the Supreme Court eliminated the physical presence requirement and ruled that the correct standard in determining the constitutionality of a state sales tax law is whether the tax applies to an activity that has "substantial nexus" (sometimes referred to as "economic nexus") with the taxing state.

In Wayfair, the Court found that the South Dakota law contained adequate safeguards as it expressly prohibited retroactive liability and required remote sellers to collect sales tax only where the seller had at least:

a. $100,000 in sales to South Dakota customers in a year, or
b. 200 sales transactions to South Dakota customers in a year.

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Although the Court ruled that South Dakota law met the “substantial nexus” requirement and thus was constitutional, it did not further define the term. Thus, the Wayfair decision serves as a guide for other states attempting to broaden their tax base and as a warning to remote sellers wishing to retain a competitive advantage by not collecting sales tax.

For an existing business, the decision to register, report and comply as the states reposition their tax reporting requirements to fit Wayfair is extremely important, but not always easy to understand. Many states have already passed legislation to address how remote sellers should comply with their updated sales tax regulations after Wayfair, but those new rules can create problems when it potentially becomes necessary for a business to report.

Given the number of decisions to be made and processes to be implemented, taxpayers will need as much lead time as possible to become sales tax compliant so it is extremely important to warn and advise clients that may be impacted.

Risk Management Guidance

CAMICO strongly recommends that policyholders consider the following risk management steps. This list is not meant to be all-inclusive.

1. Send a notification letter to business clients that may be impacted by the Wayfair case to “warn and advise” of potential sales tax collection and remittance requirements. The letter should include advice and encourage clients to contact the firm if they have out-of-state sales. For defensive documentation purposes, CAMICO recommends maintaining and retaining a list detailing to whom this letter was sent. Refer to CAMICO’s sample client notification letter, titled **“Business Client Notification Letter — Out-of-State Sales (Wayfair Decision),”** which is available to download from the Members-Only Site under Knowledge Tree —> CAMICO Publications —> IMPACT —> 2018 —> IMPACT 113 or from the Engagement Letter Resource Center in the list of “Other Tax Letters” within the Tax Letters section.

2. For all tax engagements, CAMICO recommends that firms have an annual engagement letter in place detailing the scope and limits of the specific engagement including language that any additional services will be covered under a separate engagement letter. CAMICO recommends that firms include language in their tax engagement letter confirming that clients will furnish all information necessary to identify all states in which the client does business or derives income and the extent of business operations in each relevant state.

3. If the firm is engaged to prepare sales tax returns and/or engaged to assess the client’s potential sales tax exposure, CAMICO recommends that the firm have an engagement letter in place listing the specific states including language that the client is confirming that the states listed include all states from which the client derives sales. As with all engagements, other than audits, CAMICO strongly recommends firms include language in engagement letters that the firm will not audit or verify data submitted. Refer to CAMICO’s sample engagement letter, titled **“Tax Consulting - Sales and Use Tax Nexus - Wayfair,”** which is available to download from the Members-Only Site under Knowledge Tree —> CAMICO

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Publications —> IMPACT —> 2018 —> IMPACT 113 or from the Engagement Letter Resource Center in the list of "Other Tax Letters" within the Tax Letters section.

As always, CAMICO encourages policyholders to call 1.800.652.1772 or email the Loss Prevention department at lp@camico.com for more information.

Additional information on the Wayfair decision can be found at:

https://www.supremecourt.gov/search.aspx?filename=/docket/docketfiles/html/public/17-494.html

https://www.thetaxadviser.com/issues/2018/sep/supreme-court-abolishes-physical-presence-requirement.html

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[**Note:** For liability protection purposes, your firm should maintain a list of the clients to whom this letter is sent.]

Business Client Notification Letter — Out-of-State Sales (Wayfair Decision)

<Date>

<Client Representative>
<Client Name>
<Client Address>

RE: **Additional Sales Tax Collection and Reporting for Out-of-State Sales May Be Required**

Dear <Client Representative>,

The purpose of this communication is to inform you of recent developments related to sales and use tax that may affect your business.

As a result of a recent Supreme Court decision, South Dakota v. Wayfair, Inc. ("Wayfair"), businesses that engage in out-of-state sales (i.e., remote sales) may be required to collect and remit sales tax, even where the seller has no physical presence in that state. This court ruling overturns decades of established law that required businesses to have a physical presence in a state as a standard for determining "sufficient contact" before that state could require them to collect and remit sales tax on purchases by customers within the state's jurisdiction.

Unfortunately, complexities and uncertainties exist with sales tax compliance for businesses. At the heart of the Wayfair decision is a redefinition of what is deemed to be "sufficient contact" from a physical presence standard to a much broader standard that looks at a business' economic presence in a given state. Currently, there is no conformity among the various states with respect to the definition of "sufficient contact" in a given state, much less the thresholds used by the states to define "sufficient contact." Depending upon the thresholds set by a particular state, the Wayfair case can affect both large and small businesses. While some states have already enacted rules addressing the taxation of remote sales, it is likely that other states will follow suit. Knowing the new rules and whether you have significant contact in a state under the thresholds that are in place is an important first step in identifying your sales tax risks.

We encourage you to act now to address the implications of these new rules to your business, as companies who do have sales tax exposures under the new rules will face a number of decisions, as well as potential new processes to be implemented, which could take time and resources. In addition, we strongly recommend that you consult with your technology professional to determine the appropriate system modifications that may be necessary to capture the required information for the collection and remittance of sales tax for the various states.

<If you need our assistance to help you address the sales tax exposure to your business, please contact us to learn more about our services in this area.> or <We recommend you consult with a qualified professional that is committed to monitoring tax law related to the Wayfair decision to help you address the sales tax exposure to your business.>

Sincerely,

____
<Accountant Name>
<Firm Name>

[*Please note the following before using this letter:* In CAMICO's experience, plaintiffs' counsel will try to expand the scope of a CPA's prior engagement to the widest extent possible so that the engagement will then include the subject of the litigation. Therefore, to protect yourself from this "scope expansion," (i) be as specific as possible in the section that describes your engagement (the more specifically you describe the engagement, the stronger the protection the engagement letter will provide); and (ii) if your engagement expands beyond the scope of the initial engagement letter, prepare a new engagement letter that describes the new services to be rendered. CAMICO strongly recommends that you carefully avoid vague, all-encompassing engagement descriptions and/or expanding your services beyond what is described in an engagement letter.]

<Date>

<Client Representative>
<Client Name>
<Client Address>

Dear <Client Representative>:

This letter is to confirm our understanding of the terms and objectives of our engagement as well as the nature and limitations of the services we will provide. Please read this letter carefully, as it is important to both <Firm> and <Client> that you understand and accept the terms under which we have agreed to perform our services.

Services
You have asked our firm to assist your company with assessing your sales and use tax risks and potential exposure to substantial ("economic") nexus following the recent 2018 Supreme Court Ruling on South Dakota v. Wayfair. We will use our professional judgment and expertise to help you assess your potential exposures, and will provide in writing any recommended courses of action for the following states you have identified:

- [*list states to assess*].

By your signature below, you are confirming that the states listed above include all states from which you derive sales. In addition, you will provide us with the gross sales and extent of business operations in each state. We will not audit or verify the data you submit, although we may ask you to clarify it or furnish us with additional data.

The recommendations we may make regarding the sales and use tax collection and remittance requirements for the states listed above reflect our professional judgment based on the facts provided to us by you, and the sales tax reform changes as currently promulgated by the states. Subsequent developments changing the facts provided to us, or future changes to the sales tax rules in the states noted, may affect the advice previously provided. These effects may be material. The advice and services provided hereunder are solely for the benefit of management and are to be used for no other

purpose. We assume no responsibility to keep <Client> apprised of developments in the tax law relative to this engagement after it has been completed.

We are not attorneys; therefore, we will not give any legal advice as part of this engagement. At your written request, we will participate in discussions with any professional advisors of your choosing (e.g., attorney, etc.) regarding our advice or recommendations.

If we are engaged to assist in the implementation procedures of the advice offered, we will continue to advise you of any changes as warranted by new developments from state tax authorities; otherwise, we cannot be held responsible for changes occurring between the time we offer advice and the time you implement it.

As our engagement is limited in nature, our services will not include the preparation of sales and use tax returns or other tax filings that you may be obligated to submit to the taxing authorities or other governmental agencies. If you would like to retain our services for the preparation of sales and use tax returns and/or other required filings, we will cover the terms and conditions of those services under a separate engagement letter(s).

Management Responsibilities

[*For attest clients include the following language in your engagement letter:* By your signature below, you acknowledge that you are responsible for management decisions and functions. That responsibility includes designating a qualified individual, preferably within senior management, with suitable skills, knowledge and/or experience to be responsible and accountable for overseeing all the specific services we perform as part of this engagement, as well as evaluating the adequacy and results of the services performed. You are responsible for establishing and maintaining internal controls, including monitoring ongoing activities.]

Management is responsible for, and shall make, all decisions in connection with the limited consulting services provided under this agreement. This responsibility includes making the final decision regarding implementation of any of the recommendations we may make as part of this engagement.

In addition, management is responsible for providing us with access to all information of which management is aware that is relevant to this engagement, such as records, documentation, and other matters, as well as additional information we may request for this engagement. You understand and acknowledge that management is responsible for the accuracy and completeness of the records, documents, explanations, and other information provided to us, including management's significant judgments and assumptions impacting the company's anticipated sales and extent of business operations in each state listed above.

By your signature below, you acknowledge that management recognizes the inherent limitations of this engagement as there may be subsequent developments issued by the applicable tax authorities that may affect the information we have previously provided, and/or changes to the facts management has provided to us. The effects of such changes may be material.

Our engagement cannot be relied upon to disclose errors, fraudulent reporting, misappropriation of assets, or noncompliance with laws and regulations that may have occurred. By your signature below, you acknowledge and agree that management is responsible for preventing and detecting fraud.

Other Matters
Federal law has extended the attorney-client privilege to some, but not all, communications between a client and the client's CPA. The privilege applies only to non-criminal tax matters that are before the IRS or brought by or against the U.S. government in a federal court. The communications must be made in connection with tax advice. Communications solely concerning the preparation of a tax return will not be privileged.

In addition, your confidentiality privilege can be inadvertently waived if you discuss the contents of any privileged communication with a third party, such as a lending institution, a friend, or a business associate. We recommend that you contact us before releasing any privileged information to a third party.

If we are asked to disclose any privileged communication, unless we are required to disclose the communication by law, we will not provide such disclosure until you have had an opportunity to argue that the communication is privileged. You agree to pay any and all reasonable expenses that we incur, including legal fees, that are a result of attempts to protect any communication as privileged.

Our fees for this work will be at our regular hourly rates for the individuals involved plus out-of-pocket expenses. Payment for services is due when rendered, and interim billings may be submitted as work progresses and expenses are incurred. Billings become delinquent if not paid within <number> days of the invoice date. If billings are past due in excess of <number> days, at our election, we may stop all work until your account is brought current or withdraw from this engagement. <Client> acknowledges and agrees that we are not required to continue work in the event of <Client>'s failure to pay on a timely basis for services rendered as required by this engagement letter. <Client> further acknowledges and agrees that in the event we stop work or withdraw from this engagement as a result of <Client>'s failure to pay on a timely basis for services rendered as required by this engagement letter, we shall not be liable for any damages that occur as a result of our ceasing to render services.

In the event our firm or any of its employees or agents is called as a witness or requested to provide any information whether oral, written or electronic in any judicial, quasi-judicial, or administrative hearing or trial regarding information or communications that you have provided to this firm, or any documents and workpapers prepared by our firm in accordance with the terms of this agreement, you agree to pay any and all reasonable expenses including fees and costs for our time at the rates specified in our engagement letter, as well as any legal or other fees that we incur as a result of such appearance or production of documents.

Because of the importance of oral and written management representations to the effective performance of our services, <Client> releases and indemnifies our firm and its personnel from any and all claims, liabilities, costs and expenses attributable to any misrepresentation by management and its representatives.

If any dispute arises among the parties hereto, the parties agree to first try in good faith to settle the dispute by mediation administered by the <Name of Association> under its applicable rules for resolving professional accounting and related services disputes before resorting to litigation. The costs of any mediation proceeding shall be shared equally by all parties.

Client and accountant both agree that any dispute over fees charged by the accountant to the client will be submitted for resolution by arbitration in accordance with the applicable rules for resolving professional accounting and related services disputes of the <Name of Association>, except that under all circumstances the arbitrator must follow the laws of <Name of State>. Such arbitration shall be binding and final. IN AGREEING TO ARBITRATION, WE BOTH ACKNOWLEDGE THAT IN THE EVENT OF A DISPUTE OVER FEES CHARGED BY THE ACCOUNTANT, EACH OF US IS GIVING UP THE RIGHT TO HAVE THE DISPUTE DECIDED IN A COURT OF LAW BEFORE A JUDGE OR JURY AND INSTEAD WE ARE ACCEPTING THE USE OF ARBITRATION FOR RESOLUTION. The prevailing party shall be entitled to an award of reasonable attorneys' fees and costs incurred in connection with the arbitration of the dispute in an amount to be determined by the arbitrator.

If this letter correctly sets forth your understanding of the terms and objectives of the engagement, please so indicate by signing in the space provided below.

Sincerely,

____
<Accountant Name>
<Firm Name>

Accepted:

____
<Client Representative>
<Client Name>

____
Date

General Data Protection Regulation ("GDPR")

General Data Protection Regulation ("GDPR") is a European mandate that went into effect on May 25, 2018. The regulation is designed to establish uniform data privacy law across the European Union, and applies to any EU established business, including U.S. companies and firms with offices in the EU.

It is critical to recognize that GDPR does have implications to U.S. CPA firms, even if the firm does not have an EU office. Reference the following scenarios:

- The firm offers services to clients ("natural persons" or "individuals") in the EU.
- The firm has personal information about "natural persons" or "individuals" in the EU.

If your firm falls into one or both of the above scenarios, you are subject to compliance with GDPR regardless of the size of your firm, or the nature of your services.

GDPR is aimed at protecting the ***processing*** of ***personal data*** of any EU individual. ***Processing*** is defined broadly to include virtually any activity that can be performed to personal data, including collecting, using, storing, sharing or transmitting personal data. GDPR defines ***personal data*** as essentially anything that can be used to identify a natural person.

Therefore, if your firm is currently performing services that involve personal data of an EU individual, or has any personal information about an EU individual in its email, document management, or marketing or contact databases, your firm may be subject to GDPR. ***Penalties for non-compliance with GDPR are potentially significant.*** If GDPR applies to your firm, and you have not already taken the necessary steps to ensure compliance, it is critically important to begin the process immediately.

Identify and map your data flows and identify if and where the firm stores any personal data of EU individuals. Once you have identified and gathered this information, it will be essential to take the necessary steps to ensure compliance with the obligations imposed by GDPR.

At a high level, GDPR compliance for a CPA firm typically includes the following elements, although this list is not meant to be all inclusive:

- Ensure awareness within your firm
- Inventory the personal data and information you hold within your firm (this should include identifying how you use the personal information and for what purpose)
- Communicate privacy information to affected individuals
- Address the firm's compliance with the ***privacy rights***[1] of the individuals to include the following specific elements:
  - The right of ***access*** to obtain a copy of the information
  - The right to ***correct*** the information

[1] A firm should be cautious as they address the privacy rights of an individual to ensure that the firm's efforts to protect the rights of an individual do not adversely affect the rights of others. In addition, a firm should not jeopardize their own compliance with professional standards. For example, the right to "erasure" needs to be clarified within the firm's privacy policy to allow the firm the right to retain such information it deems necessary under professional standards to support its work products.

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    - The right to have information ***deleted***
    - The right to ***restrict*** how a firm uses the information
    - The right to ***data portability***
    - The right to ***object*** to stop a firm from using information for a particular purpose
- Ensure procedures exist for getting required consents[2]
- Prepare for data breaches
- Implement technical and administration measures for data and privacy protection

GDPR requires extensive recordkeeping and documentation to demonstrate compliance with its requirements. As the information provided above is general in nature, it is not intended to address all aspects of GDPR compliance that may impact your firm. CAMICO strongly encourages firms to seek help from qualified legal professionals to address any exposures your firm may have with respect to GDPR compliance.

What's Next on the Horizon?

It did not take long for "GDPR lite" to come to the United States. California is the first state, although presumably not the last, to push forward a privacy initiative. California signed into law on June 28, 2018, the Consumer Privacy Act ("AB 375" or "Act"), which becomes effective January 1, 2020. It will inevitably require fine-tuning, as some critics of the legislation have deemed it overly complicated, poorly drafted and constitutionally problematic.

The California Act provides that a "consumer" (defined as a natural person who is a California resident) has a right to know what "personal information" businesses collect about them. (Personal information under the Act is defined more broadly than GDPR, which is problematic.) Further, it will require businesses to notify California consumers of the categories of information the businesses collect and will prohibit businesses from collecting additional information without further disclosure.

CPA firms doing business in California that meet the applicable thresholds for compliance with the new privacy law should begin to prepare early to implement appropriate compliance measures to meet the requirements of the Act.

For CPA firms that have already adopted GDPR compliance, measures need to be taken to ensure that the firm also conforms with the requirements of the California privacy law, as the Act defines personal information more broadly than GDPR and mandates several compliance requirements not imposed by GDPR. In addition, there are also variations in the limitations and exceptions to the privacy rights granted by the California Act, as compared to GDPR.

Risk Management Guidance

A CPA firm's compliance with applicable data and privacy laws, including but not limited to GDPR, is an extremely complex and organization-specific initiative. CAMICO strongly encourages firms to engage legally qualified professionals to discuss how GDPR, and other data and privacy protection laws, may

[2] A firm should ensure that the procedures related to consent under GDPR also include reference to, and compliance with, all applicable professional and regulatory standards. For example, the IRS has very specific written consent requirements that need to be complied with when the firm transfers confidential client tax information to a third party (even if the client is requesting the transfer).

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apply to your firm and how best to comply. CAMICO further encourages firms to **DOCUMENT** all time, money, research, risk assessments, and other steps and decisions taken by the firm to achieve compliance. This documentation will help to support the firm's good faith efforts toward compliance and accountability in the event it is ever challenged by a regulatory body.

For illustrative purposes, CAMICO developed sample engagement letter language regarding a firm's compliance with applicable data and privacy protection laws. This sample engagement letter language, titled "**Engagement Letter Guidance — GDPR**," is available to download from the CAMICO Members-Only Site under Knowledge Tree —> CAMICO Publications —> IMPACT —> 2018 —> IMPACT 113, or from the Engagement Letter Resource Center in the "Other Services Letters" section. As an aside, CAMICO has also received calls from policyholders concerned that their clients may allege that the firm should somehow be responsible for advising them with respect to the clients' privacy and/or GDPR compliance issues. If your firm is concerned about this potential risk, please consider inserting the language below in your engagement letters.

> *Management is responsible for the design, implementation and administration of appropriate data and privacy protection safeguards and policies that may be required under the laws and regulations applicable to its business. As <Firm> is not rendering any legal services as part of our engagement, we will not be responsible for advising you with respect to the legal or regulatory aspects of your company's compliance with any data and privacy protections laws, including but not limited to the General Data Protection Regulation Act.*

The preceding language is also available in the "**Engagement Letter Guidance — GDPR**" document, as noted above.

CAMICO policyholders with questions regarding this communication or other risk management questions should contact the Loss Prevention department at lp@camico.com, or call our advice hotline at 800.652.1772 and ask to speak with a Loss Prevention Specialist.

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Engagement Letter Guidance — GDPR

<u>Addendum to Engagement Letter: Firm's Compliance with GDPR[1]:</u>

During the course of our engagement, <Client> may disclose personal data to us in order that we may provide our specified services to you as outlined in the attached agreement dated <specify date of engagement letter>. In accordance with the terms set forth in our firm's *Privacy Policy,*[2] <see attached *or* which can be accessed at [website URL]>, we are responsible for complying with applicable data and privacy protection laws with respect to any personal data we process in providing our services to you, and our firm takes reasonable measures to comply with such laws and regulations. By accepting this agreement, you consent to the transfer and processing of personal data as may be necessary for the agreed upon services.

[*For use if you have clients that are within the EU to comply with GDPR:* If you are a resident of a European Union country, and you are providing us your personally identifiable information, you hereby explicitly acknowledge and agree to (1) the transfer of such information to the United States, and (2) the collection, use and disclosure of your personally identifiable information in accordance with the terms of this agreement and our firm's *Privacy Policy*. Your consent may be withdrawn at any time in accordance with the *Privacy Policy*.]

CLIENT ACKNOWLEDGEMENT:

By your signature below, you acknowledge and agree to the terms and conditions related to the transfer, collection, use and disclosure of your personal data in accordance with the firm's *Privacy Policy*.

____

<Client>

____

Date

<u>Optional:</u> **<u>Clause Disclaiming Firm's Responsibility for Client's GDPR Compliance</u>**

CAMICO has received calls from policyholders concerned that their clients may allege that the firm should somehow be responsible for advising them with respect to the clients' privacy and/or GDPR compliance issues. If

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[1] This Addendum is for illustration purposes only. CAMICO recommends that a firm consult with their own legal counsel and/or other qualified professional to ensure that they are complying with all applicable data and privacy protection laws, including but not limited to the General Data Protection Regulation ("GDPR") if clients are within the European Union.

[2] CAMICO recommends that a firm work with legal counsel and/or another qualified professional to develop and execute a Privacy Policy that meets applicable data and privacy protection laws.

your firm is concerned about this potential risk, please consider inserting the language below in your engagement letters:

Management is responsible for the design, implementation and administration of appropriate data and privacy protection safeguards and policies that may be required under the laws and regulations applicable to its business. As <Firm> is not rendering any legal services as part of our engagement, we will not be responsible for advising you with respect to the legal or regulatory aspects of your company's compliance with any data and privacy protections laws, including but not limited to the General Data Protection Regulation Act.

War Story No. 113

Subject: Difficult client

Services: Tax planning and return preparation services

The following War Story is based partly on CAMICO claims files and partly on risk exposures facing CPAs from the Tax Cuts and Jobs Act (the "Tax Act") passed into law in December 2017. All names have been changed.

Thomas and Lucy Welch owned a successful commercial table grape growing business, Vitality Vineyards, and had recently converted some of their vineyards over to wine grapes. This spurred exceptional new business growth that prompted them to acquire more vineyard properties, which in turn required them to hire more employees and purchase more equipment to keep up with the increasing demand for grapes.

When their accountant, Ed Beatty, retired, they had been referred to John Williams, CPA, by another business owner to provide tax planning services and prepare their tax returns. Williams spoke with Beatty, who had nothing but good things to say about the Welches, but warned Williams that there had been some high turnover and disorganization in Vitality's accounting and financial staff, which could present some challenges as the company became busier as a result of its recent growth. The tax law changes and opportunities brought about by the Tax Act would make those challenges even more complex.

Williams was interested in bigger clients in the vineyard and wine business, though, so he decided to accept Vitality in hopes of attracting similar clients. He sent an engagement letter that addressed his expectations of Vitality to provide timely information and documents, and the letter outlined terms of fee collections and the consequences of late payment. The client returned a signed copy of the letter, as requested.

When Williams requested information from Vitality's accounting and financial staff, he found that the staff and the company's records were inadequate and poorly organized. He advised Vitality's CFO and accounting staff about opportunities related to new deductions and strategies related to the Tax Act, but the CFO and staff seemed too overwhelmed by their current problems to devote enough attention to understanding the tax planning issues.

Williams documented his advice on the potential opportunities in a lengthy, detailed memo, citing IRS instructions, forms and examples of deductions and deduction limitations. He sent the memo to the CFO and Vitality management, but was frustrated by their lack of responsiveness. He was also frustrated by Vitality's poor bookkeeping and slow payment of his invoices. Williams communicated in writing to Vitality's management about his difficulties in obtaining information, documents, responses and payments.

He approached another company at a wine industry event with his ideas for tax deductions and was engaged almost on the spot. The company was so much better organized than Vitality that Williams disengaged from Vitality after one year of tax return preparation.

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A year after that, Williams was sued by Vitality, alleging that he had caused Vitality to miss more than $100,000 worth of tax deductions on the company's federal and state tax returns for the year he had prepared them.

After reading the following questions, select the one answer that is the best response.

1. **How had the CPA protected himself against the allegations in this claim scenario?**
    a. He had sent an engagement letter detailing the client's responsibilities and received a signed copy of it back from the client.
    b. He had documented the advice he had discussed with the client as well as the difficulties in obtaining documents, information, responses and payments.
    c. He had performed adequate client screening for this client.
    d. a. and b.
    e. a., b. and c.

2. **What was the main tip-off from the prior CPA that the client might be a problem?**
    a. The client was experiencing exceptional growth at a time when tax law changes would pose extra risk.
    b. The client had experienced high turnover in its accounting and financial staff.
    c. a. and b.

Answers

1. Answer a. Correct, but there's a better answer. Getting a signed engagement letter from the client clarifies that the client understood and accepted the responsibilities and obligations as set forth in the letter. This becomes a crucial part of the CPA's defense if the client claims that the responsibilities were not understood. **Sample engagement letter templates** can be found in the **Engagement Letter Resource Center** on the **CAMICO Members-Only Site.**

    Answer b. Correct, but there's a better answer. Documentation of advice provided by the CPA, and of difficulties in obtaining information, are also crucial in defending the CPA against allegations. CPAs are generally considered to be experts in documentation, and falling short of that expectation may cause CPAs to be viewed as falling below the standard of care for the services rendered. In some engagements, CPAs should obtain the client's written consent to implement decisions made, often done with an "informed consent" letter that provides the CPA's advice and obtains the client's understanding and consent.

    Answer c. Incorrect. Client screening for this client was not adequate, and the CPA chose to ignore the prior CPA's warning about high staff turnover and disorganization. A "**Client Assessment Checklist**" is available in the **Engagement Letter Resource Center** on the **CAMICO Members-Only Site** in the "**Getting Started**" section.

    Answer d. Correct, and the best answer. Getting a signed engagement letter and documenting the engagement details are essential lines of defense against allegations. In some cases, the client will agree to dismiss the lawsuit when faced with the documentation in support of the CPA.

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Answer e. Incorrect, as explained in Answer c. Client screening for this client was not adequate, and the CPA chose to ignore the prior CPA's warning about high staff turnover and disorganization.

2. Answer a. Incorrect. The engagement may pose extra risk, but extra risk can be managed with sound practices such as client screening, signed engagement letters, and thorough documentation. The engagement may also pose extra opportunities for the client, which may result in extra opportunities for the CPA, such as additional service offerings in a future engagement.

   Answer b. Correct. High client staff turnover is a red flag. Further client screening may have also revealed that the client's business and accounting records were inadequate and disorganized.

   Answer c. Incorrect, as explained in Answer a.

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