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AICPA accountant's liability newsletter

AICPA Professional Liability Plan

Number 5: January 1984

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AVOIDING TAX SHELTER PROBLEMS

Do your clients ask about investing in tax shelters? Some CPAs report advising clients to stay away from all tax shelters and then losing the clients to more aggressive firms. One CPA reports the client is threatening to hold him responsible because he discouraged an investment that has now tripled in value.

Because of new IRS penalties and the current IRS scrutiny of tax shelters, many CPAs are considering the risks to themselves resulting from client involvement in tax shelters. The following discussion outlines some of the considerations when establishing your firm's policies and practices.

New IRS Weapons

TEFRA provided the IRS with three new weapons used in its current attack on tax shelters. The substantial underpayment penalty targets investors while two provisions that deal with abusive tax shelters are aimed at promoters and their lawyers and accountants.

Substantial Understatement Penalty on Tax Shelter Deductions

IRC § 6661 provides a 10 percent penalty on substantial understatements of tax liability. This penalty can generally be avoided by a disclosure statement on the return or substantial authority for positions taken. Substantial authority means the Internal Revenue Code, regulations, revenue rulings, or revenue procedures; treatises, journal articles, or lawyers' opinions do *not* qualify.[1]

In the case of tax shelter items, disclosure cannot avoid the penalty and substantial authority can avoid the penalty only where the taxpayer reasonably believes the tax treatment on the return is "more likely than not" the proper treatment.

Promoting Abusive Tax Shelters

IRC § 6700 imposes a penalty of $1,000 or 10 percent of the gross income from the activity on those

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NEW MEMBERS JOIN COMMITTEE

Written by William J. Crowe II
Senior Vice President
Rollins Burdick Hunter Co.
Call toll free: 800-221-3023

New members, Norman C. Batchelder (New Hampshire), Joseph B. Dresselhaus (Nebraska), Cecil B. Humes (California) and Howard A. Mesh (Florida), joined with members Robert D. Hunter (New Jersey), Walter R. Stock (Texas), and Chairman Steven N. Kreisman (Denver) for the November committee meeting in New York. The plan insures only local or regional firms, and the committee membership is limited to firms in this size range.

Pictured left to right are AICPA insurance plan committee members Norman C. Batchelder, Cecil B. Humes, Howard A. Mesh, Joseph B. Dresselhaus, Walter R. Stock, Steven N. Kreisman and Robert D. Hunter.

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assisting in organizing or promoting a tax shelter who make statements concerning tax benefits which they know or have reason to know are false.

IRC § 7408 gives the IRS authority to enjoin abusive tax shelters regulated by IRC § 6700. The IRS has already obtained several injunctions pursuant to this authority.

Tax Shelter Leaks

Recent court decisions reveal new problems for shelters that result in a loss of deduction for the investor:

- Where the shelter does not engage in a businesslike manner in profit-oriented operations, deductions of the shelter are limited to gross income pursuant to IRC § 183 so there is no loss to pass through. Evaluation of operations is at the partnership level.[2]
- Syndication costs can neither be deducted nor amortized by partnerships or limited partnerships. This includes finder's fees, commissions, cost of tax opinion letters, projections and printing of the offering materials.[3]

New Standards For Tax Opinion Letters Included In Offering Materials

Proposed amendments to Circular 230 (31 C.F.R. § 10.33) require tax practitioners providing tax shelter opinions to include:

- An opinion whether it is "more likely than not" that an investor will prevail on the merits of each material tax issue or describe the inability to provide such opinion, and
- An overall evaluation of the extent to which the material tax benefits in the aggregate are likely to be realized.

The IRS has made it clear that it is no longer appropriate to issue negative opinions stating that "in the aggregate, the material tax benefits of the offering are not likely, if litigated, to be allowable." This is particularly objectionable if the opinion adds that there is a "reasonable basis" for the tax return treatment advocated by the promoter. The reason is that these opinions encourage potential tax shelter investors to pursue conduct which the practitioner believes is contrary to the tax law.

Civil Liability For Shelter Advice

CPAs do not guarantee their advice. For example, in a Minnesota case[4] the court held the CPA not liable for the tax shelter loss and said: "He was bound to exercise care in recommending a particular investment, but he cannot have been expected to guarantee its soundness." However, in other situations investors have recovered from the tax practitioner. Liability has been based on the CPA firm's participation in the sale of limited partnerships that were in violation of state blue-sky laws[5] and on the CPA firm's issuance of a misleading tax opinion letter in violation of section 10(b) of the Exchange Act.[6] In one case the client was awarded $43,000 compensatory damages and $37,500 in punitive damages against an attorney who fraudulently induced his client to put money "down the drain" into an ineffective tax shelter.[7]

Warning Clients of Risks

Many CPAs, who decline to assume risks associated with advising as to a particular investment decision, undertake to warn clients about risks associated with shelters in general and considerations relevant to a particular shelter opportunity. These include:

- The alternative minimum tax,
- The "cross over" problem where income will exceed cash flow, and
- Income recognition on disposal of the shelter which may result from realization of nonrecourse debt.

Evaluation of the impact of a tax shelter is a complex matter. The effect on tax and on alternative minimum tax must be measured for each future tax year including the year of disposition. Not all clients want to pay for this kind of detailed analysis.

Conclusion

Based on increasing risks to themselves, many CPAs are insisting on greater client compliance with IRS rules in tax return situations. This necessarily carries over to the tax advice area. The role of advisor must be distinguished from the role of advocate. A good advisor challenges assumptions, forces exploration of alternatives and clarifies underlying personal values and business goals. The purpose is to provide clients with an informed understanding of their rights and obligations in the practical application of the tax law.

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[1]Reg. § 1.6661-3 (proposed).
[2]Brannen v. Commissioner, 78 T.C. No. 471 (1982).
[3]Flowers v. Commissioner, 80 T.C. 49 (1983).
[4]Midland National Bank of Minneapolis v. Perranoski, 299 N.W.2d 404 (Minn. 1980).
[5]Hild v. Woodcrest Ass'n, 391 N.E.2d 1047 (Ohio Common Pleas 1977).
[6]Sharp v. Coopers & Lybrand, 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982).
[7]Yarbrough v. Cooper, 559 S.W.2d 917 (Tex. App. 1977).

COMMITTEE *(continued from page 1)*

The committee has oversight responsibility for the entire plan operation including selection and evaluation of the broker and the underwriter. This plan offers the insured CPA who feels aggrieved by any action of the broker or the underwriter an option of appeal to this committee for remedial action. If you have any question about this plan, your committee members can help you find the answer.

The committee usually meets quarterly, and meeting locations are rotated throughout the United States. Questions for the committee may be mailed to William Tamulinas at the AICPA.

HOW STRUCTURING NONRECOURSE DEBT CAUSES PROBLEMS FOR TAXPAYERS

- IRC § 752 permits an increase of basis for an increase in partnership liabilities (limited to the fair market value of the encumbered property).
- Reg. § 1.752-1(e) permits an increase in basis for a limited partner's share (profit ratio) of nonrecourse debt where none of the partners has personal liability.
- While nonrecourse debt cannot be included in calculating the amount at risk under IRC § 465, real estate (and related personal property and services) is exempt from the at-risk rules.
- In *Laney v. Commissioner*, 674 F.2d 342 (5th Cir. 1982), the taxpayers deducted $698,466 in losses after a cash contribution of $1,000 for a limited partnership interest in a real estate development project. Losses in excess of $1,000 were disallowed because the corporate general partner had previously assumed personal liability and brought that liability to the partnership.
- In *Commissioner v. Tufts*, 83-1 USTC ¶ 9328 (1983), the loan for a real estate complex was made to the limited partnership on a nonrecourse basis. The U.S. Supreme Court held that partners realized the full amount of the nonrecourse obligation when they sold their partnership interests resulting in capital gains and recapture of ordinary income under IRC § 1250. The Court also held that the amount realized is not limited to the fair market value of the encumbered property. The Court distinguished the fair market value limitation of IRC § 752 which deals with transactions between the partner and the partnership.

HOW STRUCTURING NONRECOURSE DEBT CAUSES PROBLEMS FOR TAX PRACTITIONERS

In *Boyles v. Dodge*, CCH Fed. Sec. L. Rep. ¶ 98,467 (N.D. Ill. 1982), limited partners sued the accounting firm and the attorney for the limited partnership based on section 10(b) of the Exchange Act and common law negligence. They alleged the offering memorandum was deficient because it failed to disclose that the general partner was personally liable on the permanent financing which caused tax losses to be limited to cash investments and destroyed the claimed tax-shelter benefits.

The accounting firm contended that it did not have knowledge of the recourse nature of the obligation since the attorney never mentioned it. Plaintiffs contended that the accountants knew of the key documents when preparing its tax forecasts and that their reliance on the attorney instead of examining the documents was at the very least reckless. The court held that the issues should be resolved at trial and denied motions of the parties for summary judgment.

WHEN TO REPORT CLAIMS

Written by H. James Cantwell,
Member of the Illinois Bar
Senior Vice President-Claims
L. W. Biegler Inc.
(Underwriter for the AICPA Plan)
Call collect (312) 876-3162

A number of CPAs, lawyers, and other professionals have encountered a disastrous loss of insurance coverage because of failure to *immediately* report claims or *potential* claims to the insurance carrier. This article outlines these aspects of your reporting duty:

- Claims-made coverage,
- Notice as a condition of the policy, and
- The carrier's right to control negotiations and litigation.

Claims-Made Coverage

Your policy has "claims-made" or "discovery" coverage. This means that it insures only claims reported to the Company during the policy period. It excludes any claim that you know about or can reasonably foresee at the inception date of the policy.

Your policy period is strictly construed. There is *no* reasonable period for reporting after the policy period ends. For example, on the last day of the claims-made policy, a law firm received a client's letter alleging negligence[1] About seventeen days later the lawyers notified their new claims-made insurance carrier about the claim. The Supreme Court of Florida held that neither policy covered the claim. The claim was not reported during the policy period of the old policy and the new policy excluded any claim that the insured knew about on the effective date.

The lawyers argued that "in order to make the contract fair" there should be a reasonable time after the old policy expired for reporting claims discovered late in the policy period. The court rejected this argument noting that claims-made or discovery policies are essentially reporting policies. The court reasoned that an extension of the reporting period would be tantamount to rewriting the contract between the parties.

Notice as a Condition of the Policy

Your policy makes it a condition of the policy that you give immediate written notice of any claim or of "an incident or circumstance likely to give rise to a claim" to:

L. W. Biegler Inc.
100th Floor–Sears Tower
233 South Wacker Drive
Chicago, Illinois 60606

Failure to give the required notice can result in loss of your coverage. Your reporting duty includes situations where:

- You know of an error or deficiency in your work but your client does not.
- Your client or your client's attorney notifies you that you are expected to make good on losses resulting from your work.
- You are served with a lawsuit alleging deficient performance.

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REPORT CLAIMS (*continued from page 3*)

The Carrier's Right to Control Negotiations and Litigation

Your policy provides that "the Company shall have the right to make such investigation and negotiation of any claim as may be deemed expedient by the Company." It also states: "The Insured shall not, except at his own cost, admit any liability, voluntarily make any payment, assume any obligation or incur expenses of any kind." These provisions give the Company the exclusive right to control any negotiations and defense. Undertaking to settle your own case leaves you entirely uninsured with respect to the matter you are negotiating. Any legal expenses that you incur prior to consent of the Company must be at your own expense.

Never discuss settlement with the client. Never admit liability. Remember these rules:

- Do not make any admissions of fault.
- Do not make statements like "my insurance company will take care of you."
- Do not tender or offer to pay damages even if you feel responsible.

Summary

When do you report a claim or a potential claim to L. W. Biegler Inc.? The answer is immediately! Never negotiate the situation on your own without prior consent of L. W. Biegler. Remember that the failure to follow these rules can result in the entire loss of your insurance coverage.

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[1]433 So. 2d 512 (Fla. 1983).

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The contents of this newsletter do not represent an official position of the AICPA Professional Liability Insurance Plan Committee.

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SPECIAL 1984 TAX ISSUE