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Accountant's Liability Newsletter, Number 6, May 1984

Rollins Burdick Hunter Company

American Institute of Certified Public Accountants (AICPA)

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AICPA accountant's liability newsletter

AICPA Professional Liability Plan

Number 6: May 1984

Accounting Practice Pointers:
No. 6 of a Series

AVOIDING IRS PENALTIES

The Problem

An Eighth Circuit case[1] demonstrates your exposure where clients pay their personal expenses out of their closely held corporations. The IRS assessed $3,000 in civil penalties against an Arkansas CPA for his "willful understatement" of tax liability of his closely held corporate client and its shareholders.

Pursuant to the procedures under IRC §6694 the CPA paid 15 percent of the penalties and filed a claim for refund and a request for abatement of the balance. The refund claims were disallowed and in order to avoid IRS levy for the balance the CPA had to file suit in federal district court. The court upheld assessment of two $500 penalties for personal items on corporate returns and held the CPA not liable for penalties for "oversight" on personal returns. The CPA appealed the $1,000 assessment to the U.S. Court of Appeals for the Eighth Circuit in St. Louis which affirmed imposition of the penalties.

The basis for upholding the penalties was testimony by the bookkeeper:

> Mrs. Smith said she was concerned about bills and expenses which were submitted to the corporation for personal expenses of the shareholders and their children. Such expenses were repair bills for cars used by the children of Leonard Thompson and Gail Richardson, taxes and licenses for the automobiles, gasoline bills and insurance for those cars, and the weekly salary paid to Richy Richardson, who was at college in Fulton, Missouri.
>
> Mrs. Smith said she asked plaintiff about those expenses and what the IRS would do about them if there was an audit. Pickering told her "not to

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TIPS FOR ENGAGEMENT LETTERS

- The main need for engagement letters is for non-audit engagements in order to show that you do not have audit responsibility.
- Unless you have an audit engagement letter providing for progress billings, you cannot enforce progress billings either by suit or suspension of audit work. The reason is that a contract to audit is an "entire contract."
- There is no magical clause to insert in order to eliminate professional responsibility. The best approach is to focus on the objective and scope of the engagement. Where the client has an untrained bookkeeper, consider whether you are assuming responsibility to evaluate compliance as to sales tax, workers' compensation and other insurance coverage, payroll tax returns, estimated tax returns, business licenses, corporate or business franchise taxes, and fidelity bonding.
- Provide for billing at thirty-day intervals based on standard rates that vary depending upon who performs the service and the nature of the service performed. Make balances payable immediately upon presentation of the invoice.
- Provide that the client must sign an interest bearing promissory note providing for payment of attorney's fees and costs of collection whenever any balance is thirty days past due. Then you can start an account at your client's bank and place the note with your bank for collection.
- The shareholder's guarantee of payment of the bill for the closely held corporation should be in writing. Any promise to answer for the debt of another may be within the Statute of Frauds.
- The courts are split as to an attorney's personal liability for services obtained in aid of litigation for a named client. Ask the attorney to sign an engagement letter accepting personal responsibility.

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worry about it." Mrs. Smith also pointed out that Pickering was aware of the automobiles purchased by the company and that he set up depreciation schedules for the vehicles.[2]

The Range of Risks

Consider these alternative approaches for dealing with personal expenses paid by your closely held corporate clients:

1. Ask the bookkeeper for a list of the items to classify as dividends instead of expenses and pick up dividend income on shareholder returns.
2. Advise the setting up of accounts or notes receivable to be paid back with checks from the shareholders.
3. Advise the setting up of accounts or notes receivable to be later charged off to a bonus or salary authorized by minutes of the board and an employment agreement and subjected to withholding tax.
4. Permit a current deduction to the corporation for the expenses but pick up income to the shareholders on their returns.

These choices are listed in order of least risk to highest risk of loss to you and your clients.

Dividend Treatment

Dividend treatment was the treatment required by the court. It is a well established rule that, regardless of the amounts in question, any payments made by a corporation for the personal benefit of its shareholders will constitute a constructive dividend. Thus in a private letter ruling the IRS advised that personal use of a corporate auto could not be considered executive compensation.[3] In a case dealing with personal use by a physician of the corporate Mercedes, the Tax Court required dividend treatment on the corporate books and dividend income to the physician based, not on cost, but on fair rental value.[4] Similarly in another case requiring the shareholder to include fair rental value of the use of the auto as dividend income the court held that the rule is well established that a dividend in kind is measured at fair value and not cost to the corporation.[5]

Receivable Treatment

Treating all personal items as a receivable that must be paid back by a check is also regarded as conservative. However, taxpayers should be cautioned that it may be necessary to pay back full value where it exceeds cost in order to avoid dividend treatment. Leaving the receivable on the books without repayment creates a significant risk of dividend treatment.

Charge off Against Current or Future Compensation

Some clients like to decide on the amount of bonuses to be taken for the fiscal year *after* the fiscal year is closed. Unfortunately this is not possible. Unless the salary or bonus is *authorized* and *documented* on or before the last day of the fiscal year, the deduction will be disallowed. In a few cases the courts have permitted a deduction where they believed the bonus was authorized during the year but the authorization was not documented. However, most of these cases go against the taxpayer.[6] For this reason, charge-off against current compensation must be regarded as too risky despite issuance of a 1099 and inclusion on shareholder returns. The fact that the items have not been subjected to withholding and included in a W-2 further weakens the case. While offsetting future compensation can overcome the problem of authorizing and documenting the bonus, it is a much weaker defense against the IRS dividend argument than the receivable approach. Clients who insist on this treatment should be warned that the probable consequences are IRS disallowance of deduction and assessment of penalties and interest.

Conclusion

Now is the time for addressing personal expenses paid by your closely held clients. These items constitute risks of preparer penalties. One approach might be to develop a newsletter to your clients explaining the risks and prudent approaches with a suggestion that they consult you now in order to resolve the issue before it's too late. This can generate new fees while performing an invaluable benefit to the client by reducing exposure to assessment of IRS penalties and interest.

Here are some considerations for inclusion in this communication to clients or in the ensuing discussion:

- It is possible to base a bonus on profits even in a sole shareholder corporation provided the bonus formula is documented prior to year end. In *Elliotts, Inc. v. Commissioner*,[7] the sole shareholder received a salary of $2,000 a month plus a bonus of 50 percent of profits at year end. IRS claimed the compensation was excessive and the Tax Court agreed based on a lack of dividend paying history. However, the Ninth Circuit reversed and remanded because the IRS failed to consider compensation for each of the several functions that were performed in similar firms by more than one person. The absence of dividends was not conclusive where corporate profits still represented a reasonable return of 20 percent on shareholder equity.
- An employee's agreement to repay compensation which IRS determined to be excessive was upheld in *Van Cleave v. United States*.[8] The IRS acknowledged that the payback agreement could warrant a tax deduction for the year when the payback occurred. However, the court held that pursuant to IRC §1341, the employee could recoup the taxes paid in the higher tax bracket in the prior year when he received the compensation.

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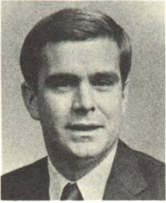
COURT DECISIONS OF INTEREST



Written by Scott Carey
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California Joins Iowa in Limiting Accountants' Liability to Third Parties

California has joined Iowa in greately limiting the ability of nonclient third parties to sue CPAs for negligence. Nonclient plaintiffs must show that the end and aim of the CPA's work was to influence plaintiff's conduct. A trial court in California recently granted summary judgment for a CPA who was unaware, at the time of audit, that the financials would be used later by the mortgage company client in obtaining mortgage purchase commitments from plaintiff. The evolving rule in California, enunciated in another recent California case, is that an incidental beneficiary cannot sue on the contract or for negligence. This case involved suit against a title company for its failure to disclose plaintiff's lis pendens in its title report. The court cited other title company cases and said:

> In each case cited above title companies were found liable only to persons (1) for whose guidance information was supplied; (2) who justifiably relied on the information; and, most importantly, (3) who were intended to be influenced by the communication. Intent to influence is a threshold issue. In its absence there is no liability even though a plaintiff has relied on the misrepresentation to his or her detriment and even if such reliance were reasonably foreseeable.
>
> In the instant case, although respondents are professional suppliers of information, they did not supply information for Stagen's guidance, but rather for that of the buyers. Thus, any failure to exercise care in obtaining and communicating the fact that a lis pendens affecting the subject property had been recorded by Stagen would have been actionable only by the buyers.[1]

A federal court in Iowa, applying Iowa law, had earlier dismissed a negligence claim against an accounting firm because at the time of the audit the accountants had no knowledge of plaintiffs' subsequent use of the audit in acquiring securities of the client. The court said:

> Imposition of a broad duty of care upon accountants to all third parties who might foreseeably rely upon negligently prepared or certified financial statements would have an extremely disruptive effect on current accounting practices. To protect themselves the accountants would greatly increase the costs of the audit to the client. Ultimately such cost would be borne by lenders, investors and the general public. Present methods of raising risk capital would be put in jeopardy. In the Court's opinion, such additional costs of insuring against potential liability would far exceed the benefits to be derived from spreading the particular risk of loss involved herein to the public at large.
>
> Absent any indication in the record concerning defendants' actual knowledge of the intent of the recipient of the challenged statements, IPSCO, to supply such statements to the particular plaintiff investors, or a limited identifiable class of investors, the Court is convinced that [the accountants] are entitled to summary judgment.[2]

Refusing to Release Audit Unless Client Signed Note Was Not Duress

When the CPA sued to enforce two promissory notes signed by the client, the client claimed the notes were signed under duress because the CPA would not sign and transmit the audit unless the notes were executed. The terms of the engagement provided for monthly billings payable immediately upon presentation. In ruling for the CPA the court held that insisting upon signing of the notes was enforcing the CPA's legal rights which is not coercion or duress.[3] The court also upheld the provision for a 25 percent attorney's fee, and ruled that the provision for 15 percent interest was not usurious because the Louisiana usury law did not apply to a commercial undertaking.

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[1] Stagen v. Stewart-West Coast Title Co., 83 Daily Journal D.A.R. 3392 (Cal. App. Oct. 31, 1983).
[2] Briggs v. Sterner, 529 F. Supp. 1155 (S.D. Iowa 1981).
[3] Gallent v. Womack, 415 So. 2d 362 (La. App. 1982).

PENALTIES *(continued from page 2)*

- IRC §267 disallows expenses to over 50 percent owners and family members unless they are paid within two and one-half months after the close of the fiscal year. It places deduction of expenses paid to 2 percent shareholders of an S corporation on a cash basis.

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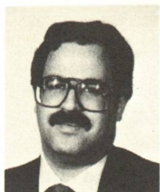
[1] Pickering v. United States, 691 F.2d 854 (8th Cir. 1982).
[2] Quoted from Pickering v. United States, 82-2 USTC ¶9375 (E.D. Ark. 1982).
[3] See the *Journal of Taxation*, June 1983, p. 366.
[4] Egan v. Commissioner, TC Memo. 1982-237.
[5] Tanner v. Commissioner, TC Memo. 1983-230.
[6] Refer to Prentice Hall tax service ¶11,576 or to CCH tax service ¶1370.0119.
[7] Elliotts, Inc. v. Commissioner, 716 F.2d 1241 (9th Cir. 1983).
[8] Van Cleave v. United States, 718 F.2d 193 (6th Cir. 1983).



HOW TO SHOP FOR THE BEST INSURANCE VALUE

Written by Steve Brill
Manager
Rollins Burdick Hunter Co.
Call toll free: 800-221-3023

Most CPAs wouldn't think of shopping for computers, word processors, or office space strictly on the basis of price. However, some CPAs, who don't know about the qualitative differences, opt for the cheapest insurance coverage. Here are questions considered important by over 13,000 practice units that have selected the AICPA Professional Liability Insurance Plan.

1. **Is the policy issued by a carrier admitted in your state?**
   The North River Insurance Company that issues your AICPA policy is an admitted carrier in all fifty states. This costs us money, but it assures you that your carrier is complying with the rules that your state has designed for your protection. Ask your state insurance commissioner if the lower-priced carrier is admitted in your state and what this means in terms of your protection.
2. **Is there a retroactive date?**
   In the AICPA plan you can obtain prior acts coverage if you have not been previously insured. Beware of a retroactive date in the competing policy.
3. **Are you covered for your partner's dishonesty?**
   Virtually all policies exclude affirmative dishonesty of the firm or its partners. However, the AICPA policy covers the innocent partner who neither knew about nor participated in the dishonesty.

COMMUNICATIONS OR PAPERWORK PROBLEMS?
Call Steve Brill
1-800-221-3023
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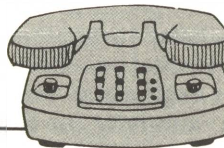

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The contents of this newsletter do not represent an official position of the AICPA Professional Liability Insurance Plan Committee.

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