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AICPA accountant's liability newsletter

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TAX ADVICE THAT PROVES DEFECTIVE

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The purpose of this article is to consider these aspects of the hazards of tax advice:

- the standard of care,
- the duty to advise of risks and uncertainties,
- monitoring implementation of complex advice,
- documentation of telephone tax advice, and
- gratuitous advice.

The Standard of Care

The standard of care for a professional person is the skill and knowledge normally possessed by members of the profession in good standing in similar communities. Deviation from this standard is negligence. You are not a guarantor of infallibility. Clients are not entitled to the best professional judgment and can expect only average care and competence.

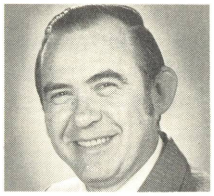
An informed judgment, even if subsequently proven to be erroneous, is not negligence.[1] When a Louisiana lawyer's tax advice proved erroneous, he was held not liable to the client for negligence.[2] The court quoted this from a North Carolina case:

> An attorney who acts in good faith and in an honest belief that his advice and acts are well founded and in the best interest of his client is not answerable for a mere error of judgment or for a mistake on a point of law which has not been settled by the court of last resort in his State and on which reasonable doubt may be entertained by well-informed lawyers.

Unfortunately you cannot gain much comfort from these authorities. Where your advice proves erroneous, the client is likely to feel dissatisfied, and the adequacy of your advice may prove to be a close

(continued on page 2)

QUESTIONS AND ANSWERS ABOUT ACCOUNTANTS' MALPRACTICE INSURANCE



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Q: Are all accountants' malpractice insurance policies alike?

A: No! There is no such thing as a standard accountants' malpractice policy. What seems like a minor difference between policies may result in a drastic uninsured loss.

Q: What are critical things to look for?

A: A few of the important things are:

- Prior acts coverage for work performed prior to the policy period.
- Protection for the innocent partner where there is affirmative dishonesty by the firm or one or more partners which most policies exclude.
- No SEC exclusion because much liability under federal securities law is conditioned, not on SEC filings, but on the sale of "securities" such as limited partnerships, stock in closely held corporations, or fractional undivided oil and gas interests.
- For your protection look for a carrier admitted to do business in your state—insurance carriers can and do fail from time to time.

Q: What is "prior acts coverage?"

A: Most malpractice policies written today are of a "discovery" or "claims made" type that cover only claims or occurrences that you report in writing during your policy period. Some policies carry a "retroactive date" so that if the work was performed prior to this date there is no coverage.

(continued on page 4)

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question for the jury. Experts for the plaintiff may convince the jury that your advice should have been correct. Consider an Ohio case[3] where the client had service stations at which he desired to pay employees a commission on sales yet avoid overtime pay. When the pay plan designed by the accountant/attorney proved defective, the client sued and recovered $14,888 in overtime deficiency. In awarding damages the trial court defined the standard of care as follows:

> An accountant has no obligation to advise a client on legal matters such as offering an interpretation of the Fair Labor Standards Act. However, if he does so, he has a duty to offer correct advice which does not cause a client to suffer damages.

Upon appeal the accountant/attorney argued that this imposed the strict duty of an insurer or guarantor. However, in affirming the verdict, the Ohio Court of Appeals held:

> Appellant is correct in arguing that a professional person is not a guarantor of infallibility, but only of reasonable competence judged by the standards of that profession in similar localities. . . .
>
> Four witnesses testified at trial as to the standards of care for accountants and labor lawyers in this area. The consensus was that the professional giving advice in this area should thoroughly research the applicable statutes and regulations; that any advice given should be correct; and that the professional should follow up with the client to make sure that the advice given was understood and being followed. The trial judge, sitting as the finder of fact, concluded that the appellant breached this standard; and, from the evidence in the record, we cannot say this finding was erroneous.

Cases like this help explain why most malpractice cases are settled. The cost of litigation and the loss of time from your practice too often make settlement seem expedient even if your advice was reasonable. Where the advice proves wrong, there is a strong chance that you may lose unless you have warned about risks and uncertainties.

The Duty to Advise of Risks and Uncertainties

When you advise of the risks and uncertainties, clients generally understand that they are assuming those risks. When you fail to warn of any risks and uncertainties, clients tend to assume there are none. You must carefully distinguish your role as an advisor from your role as tax return preparer or as your client's representative before the IRS Appeals Division. As a tax return preparer you can resolve doubt in your client's favor after:

- discussing controversial positions and obtaining client consent[4]
- evaluating your duty to maintain independence in fact[5]
- considering any possible risk to you from IRS negligence ($100) or willful ($500) preparer penalties or criminal penalties in connection with a false return[6]
- analyzing whether disclosure is needed to avoid the substantial underpayment penalty under IRC § 6661[7] or to avoid application of the six-year statute of limitations under IRC § 6501(e).

When representing a client before the IRS Appeals Division, you actually assume an advocate role. Even in this situation the CPA must request the client to disclose a known error that may result in a material misstatement and lacking such agreement may have a duty to withdraw.[8]

The role of advisor is to provide the client with an informed understanding of the client's legal rights and obligations and their practical implications. In the medical field the physician's duty to inform of risks is known as the "informed consent doctrine." This rule is that a consent to treatment or surgery given without adequate knowledge of the risks involved is not an informed consent and is ineffective. The traditional view is that the duty to inform is measured by what a reasonable physician would disclose under the same or similar circumstances. Other jurisdictions now embrace the view that a physician's duty to inform of risks is measured by the patient's need for information and not by the professional medical standard.[9]

The legal profession now distinguishes between the role of the lawyer as advisor and the role of the lawyer as advocate. American Bar Association Ethics Opinion 346 (Revised) dealing with opinions in tax shelter investment offerings states: "Since the model code was adopted in 1969, the differing functions of the advisor and the advocate have become more widely recognized." For protection from malpractice suits it is imperative to assume the advisor role whenever evaluating prospective transactions. The reason is that the failure to advise of risks such as a lack of judicial authority and the possible consequences of an IRS challenge may result in malpractice liability to the client.

Consider the case of a CPA consulted about a proposed corporate liquidation to be consumated following the sell-off of an apartment house as condominiums. The CPA suggested a liquidation under IRC § 337 without warning of inherent risks of tax planning or any lack of judicial authority concerning apartment houses under IRC § 337. When the IRS took the position that the apartments were inventory and not eligible for nonrecognition of gain treatment, the case was finally compromised in Tax Court at fifty cents on the dollar plus a large attorney's fee. Looking at this situation in hindsight the CPA should have warned about the absence of a precedent dealing with apartment houses. Rather than to say there is no case on point and to have one surprisingly show up, its safer to say what you did. For example: "I looked in the Prentice-Hall Tax Service and did not find an apartment house case under IRC § 337 in that reference." The CPA in this case wrote a three page letter giving three options; however, the lawyer's evaluation of the advice was a lengthy memorandum consisting of many pages.

While the IRS sometimes announces its acquiescence in Tax Court decisions, you cannot rely upon this in giving tax advice because the IRS can reverse positions and beat you in court despite your reliance on the prior position.[10] Always warn that a federal district court decision might be "reasonable basis," but that it provides no assurance. Even a decision of a

U.S. Court of Appeals from another circuit provides no assurance because the Tax Court has announced that it will follow as precedents only decisions of the Court of Appeals to which its decision is appealable.[11] A Court of Appeals decision in your own circuit may be overruled by the U.S. Supreme Court.

Monitoring Implementation of Complex Advice

In complex or risky situations it is often difficult to write a simple letter that the client will understand and yet cover all aspects of the problem. Try to imagine all of the complicating facts that can arise if this client tries to implement this advice without professional assistance. In these situations it may be prudent to advise that the advice is for preliminary planning purposes only and that it will be necessary for you to monitor in both planning and operational stages for other essential conditions which must be met.

Documentation of Telephone Tax Advice

Consider the case of a small CPA firm being sued for failure to mention the alternative minimum tax when being consulted over the phone concerning a prospective client investment. One managing partner says that nobody is permitted to give immediate tax advice so that the standard procedure is to call the client back after checking. Another says that clients complain when their CPA can never seem to handle questions. This firm's approach is to answer the question but to indicate that it would be best to check the tax service to see if there are any recent developments. Checking not only facilitates billing for the service but also decreases the risks to both the CPA and the client.

Some CPAs take notes on facts stated and advice given and place it in the client's file. Others send a copy to the client after routing complex ones by the tax partner. Still others type up a formal memo. Regardless of your particular procedure, checking for current developments and documenting your advice decreases the risk to you and your clients.

Gratuitous Advice

Liability is not limited to situations where you charge a fee for the service. The question is whether you gave advice in a setting in which there was reasonable expectation of reliance upon your advice in taking action without the further necessity of consulting another. Consider this from Prosser:

> An attorney or a physician who gives curbstone advice when it is requested by one who is not a client or a patient, is required only to give an honest answer. But when the representation, although itself gratuitous, is made in the course of the defendant's business or professional relations, the duty is usually found.[12]

Conclusion

Tax advice like most other areas of public accounting practice carries significant exposure to malpractice liability. Your clients usually understand risks that you explain to them. Failure to provide such explanation does the client a disservice by leading to unrealistic expectations followed by a breakdown in the professional relationship. Documentation and monitoring of complex situations can decrease the risks to both you and your clients.

[1] Lentino v. Fringe Employee Plans, Inc., 611 F.2d 474 (3d Cir. 1979) (applying Pennsylvania law).

[2] Smith v. St. Paul Fire and Marine Insurance Co., 366 F. Supp. 1283 (M.D. La. 1973), *aff'd per curiam*, 500 F.2d 1131 (5th Cir. 1974).

[3] Richard v. Staehle, 434 N.E.2d 1379 (Ohio App. 1980).

[4] TX § 201.13 states: "A tax return is primarily a client's representation, and the client has the final responsibility for whatever positions are taken in the return. Such positions should therefore be taken only with the full acquiescence of the client."

[5] ET § 52.11 states: "The CPA, in all types of engagements, should refuse to subordinate his professional judgment to others and should express his conclusions honestly and objectively." Ethics Rule 102 provides: "A member shall not knowingly misrepresent facts, and when engaged in the practice of public accounting, including the rendering of tax and management advisory services, shall not subordinate his judgment to others. In tax practice, a member may resolve doubt in favor of his client as long as there is reasonable support for his position."

[6] According to the Revenue Ruling 78-344; the $100 negligence penalty will be imposed where the tax preparer follows client instructions without making an independent evaluation of the rules applicable to the particular situation.

[7] See Revenue Procedure 84-19 which identifies specific disclosures that are adequate for this purpose and proposed regulations calling for a disclosure statement adequate to apprise the IRS of the nature of the controversy for other situations.

[8] TX § 171.04.

[9] See: Annot., "Modern Status of Views as to General Measure of Physician's Duty to Inform Patient of Risks of Proposed Treatment," 88 A.L.R.3d 1008 (1978).

[10] Annot., "Outstanding Acquiescence by Commissioner of Internal Revenue in Earlier Tax Court Decision as Bar to Assessment of Tax in Contravention of Rule Stated Therein," 42 A.L.R. Fed. 745 (1979).

[11] Golsen v. Commissioner, 54 T.C. 742, *aff'd on another issue*, 445 F.2d 982, *cert. denied*, 404 U.S. 940 (1971).

[12] W. Prosser, *Law of Torts*, 4th ed., p. 706.

QUESTIONS *(continued from page 1)*

Others provide that the work must be performed during the policy period to be covered. In one case decided by the Supreme Court of Rhode Island, the CPA firm wound up with no insurance despite the fact that at all times the firm carried insurance.[1] When the claim was first discovered the CPA failed to report it and when suit was later filed against the CPA firm there was no prior acts coverage in the policy then in effect.

Q: What is this "affirmative dishonesty" problem?

A: Suppose your partner diverts client funds! You are liable for your partner's breach of trust. If the diversion involved affirmative dishonesty, many policies afford no coverage because of an "affirmative dishonesty" exclusion. This happened to a Florida CPA firm where the court held that the misappropriation of client funds was either not "professional services" insured by the policy or was excluded as a affirmative dishonesty.[2]

Q: How does the AICPA professional liability plan rate on these critical factors?

A: Ask your own independent insurance agent to compare these points with the cheaper competing policy:

- Prior acts coverage is available under the AICPA plan; however, if you have not previously been insured, you need to ask about this and pay the additional premium that is required.
- The AICPA plan protects an innocent partner who would otherwise be excluded due to affirmative dishonesty within the firm.
- There is no SEC exclusion in the AICPA plan but if your firm does significant SEC filings, there may be a surcharge.
- The North River Insurance Company that issues your AICPA policy is admitted in all 50 states.

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[1] 383 A.2d 1024 (R. I. 1978).

[2] 468 F.2d 973 (5th Cir. 1972) (applying Florida law).

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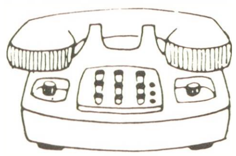

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