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Accounting Practice Pointers

COMPLYING WITH THE TIMELY-MAILED RULE FOR TAX FILINGS, ELECTIONS, AND PAYMENTS

Court decisions indicate that tax practitioners are running afoul of the timely-mailed rule for tax filings, elections, and payments. The purpose of this article is to show how to avoid these pitfalls in your practice.

Internal Revenue Code §7502 provides that returns, documents, or payments will be considered timely if postmarked on or before the required due date. The IRS retains envelopes used for mailings near the due date. Thus it is necessary to closely observe these aspects of the timely-mailed rule:

- Do not rely on a certificate of mailing
- Do not rely on a private postage meter
- Use U.S. certified or registered mail
- Mail federal tax deposits two days before the due date
- Hand carry large federal tax deposits

Certificate of Mailing

In *Haaland v. Commissioner*[1] the taxpayers' lawyer mailed a petition to the Tax Court properly addressed with postage prepaid on March 16, 1982, which was the last day on which the petition could be timely filed. The lawyer secured from a postal employee a certificate of mailing correctly reflecting the date, lawyer's name and the address of the court. When the petition was received by the court on March 22, 1982, bearing a clearly legible postmark of "March 17, 1982 PM," the Commissioner filed a motion to dismiss because the filing was not timely. Despite the fact that the Commissioner stipulated that the petition was actually mailed on March 16, 1982, the court dismissed the petition. The reason is that:

- the date of receipt in Tax Court (March 22, 1982) was untimely,
- the timely-mailed rule depends upon the postmark

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SELECTING APPROPRIATE POLICY LIMITS

In recent years, losses in the $1 million range have become relatively common even for the local CPA firm. However, nobody wants to advise you as to the appropriate policy limits—only minimum limits. The reason is that any figure selected will in some instances eventually prove inadequate. The purpose of this article is to suggest some of the benchmarks that you might use in making your own evaluation.

Some practitioners express the view that it's best to carry no insurance because they claim this avoids all suits. Unfortunately not many lawyers agree with this sentiment. One experienced defense attorney says: "I must admit that I don't know of a doctor without insurance who is being sued. However, I'm now defending some CPAs who have no coverage." The AICPA plan carries unlimited defense costs so that if you decide on coverage, your only decision is your policy limits for indemnity. While there are any number of approaches to this question, here are a few that you may want to consider:

- sale price or asset value of largest clients,
- transaction totals for largest clients,
- total dollar value of investment or management decisions that you influence,
- total tax benefit that might be lost.

Asset Values

Especially where you perform audit work, your exposure may easily run to the largest amount a purchaser will pay for an audit client plus losses generated by required additional money invested in an attempt to save the company. Audit work causes more dollar losses than any other functional category. While a director's examination for a bank may involve only selective audit steps, your exposure can run into many millions if you don't perform each of the steps you undertake with due care.

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on the envelope, and
- where the postmark is clearly legible, no extrinsic evidence can be introduced except for certified or registered mail.

The court pointed out that registered mail is covered by Code § 7502(c)(1)(B) and that certified mail is covered by Code § 7502(c)(2) and Reg. § 301.7502-1(c)(2). A certificate of mailing is not covered by the Code or regulations nor is it associated by number with the specific item mailed so as to be sufficiently reliable to overcome the presumption of a legible postmark.

Private Postage Meter

In *Guerra v. Commissioner*[2] the taxpayers' lawyers mailed a petition to Tax Court by certified mail on February 8, 1982, which was the last date for filing. It was received by the court on February 12, 1982, which was four days beyond the due date. The Commissioner moved to dismiss because the envelope bore a privately metered postmark of February 5, 1982.

The court noted that the timely-mailed rule applies only to a United States postmark. The Code provides that the timely-mailed rule applies to privately metered mail only to the extent provided by regulations. Regulations require the privately metered envelope to be received within the time it ordinarily takes for an envelope mailed on the due date.

Taxpayers' lawyers presented four affidavits from individuals associated with the law firm attesting to the fact that the petition was mailed before 5:00 p.m. on February 8, 1982. Based on testimony of a mail supervisor that it would not be unusual for a letter to take four days to go from Corpus Christi, Texas to Washington, D.C., the court held that the taxpayers had met their burden of proof that the petition was received at the Tax Court in the ordinary course of the mail. This burden could have been met much easier by simply relying upon a U.S. postmark.

U.S. Certified Mail

In *Herrera v. Commissioner*[3] the taxpayers' representative mailed their Tax Court petition from Dallas on April 21, 1983, by U.S. certified mail, and the sender's receipt was postmarked with this mailing date by the postal employee to whom it was presented. Following standard procedure, this employee verified the correct amount of postage, and then mailed the envelope. On April 25, 1983, the U.S. Postal Service returned the envelope for postage due with the postage no longer affixed to the envelope. Taxpayers' representative again mailed the petition by U.S. certified mail on April 25, 1983, and it was received by the Tax Court on April 28, 1983.

When the Commissioner moved to dismiss, the court acknowledged that the petition was not filed within 90 days of the mailing of the statutory notice of deficiency. However, the Court quoted this from Reg § 301.7502-1(c)(2):

> If the document is sent by United States certified mail and the sender's receipt is postmarked by the postal employee to whom such document is presented, the date of the United States postmark on such receipt shall be treated as the postmark date of the document. Accordingly, the risk that the document will not be postmarked on the day that it is deposited in the mail may be overcome by the use of...certified mail.

The court rejected the Commissioner's argument that the certified-mail rule applies only when the envelope is actually delivered to the Tax Court. The court pointed out that it did receive the original petition.

Federal Tax Deposits

Code § 7502(e) provides that deposits in federal depositories will be considered timely if the envelope is postmarked two days prior to the due date. However, this does not apply for deposits of $20,000 or more by any person required to deposit more than once a month. In these situations involving large depositors, the deposit must be hand carried to avoid the late payment penalty.

When the deposit is hand carried, regulations provide that the timeliness of the deposit will be governed by the date stamp on the detachable stub of the deposit form. Thus a deposit on Friday at 3:00 p.m. was ruled late where the bank had closed its business day at 2:00 p.m. and used a date stamp for the following Monday.[4] Some banks maintain a window for accepting deposits with a current date stamp for this purpose. Some CPAs report that their local collection officers agree to abate the penalty in these isolated situations.

Handcarrying to District Directors

Some CPAs send messengers to a District Director's office to file returns, elections, and extension requests. Some District Directors will stamp each copy filed and also stamp the CPA firm's file copy. However, never attempt to file by handing to a revenue agent. This is not filing even if the agent accepts it and stamps it.[5] Furthermore, the IRS has announced that it will impose a 5% penalty under Code § 6656 for mailing or delivering federal tax deposits to IRS offices instead of the authorized government depositories.[6]

Summary and Conclusion

Many CPAs have a standard procedure of logging all client tax data into the office and logging all delivery of returns or filings out. Some supplement this procedure with a transmittal letter to the IRS requesting acknowledgement of the date of receipt on a form provided. This has proved helpful where large remittances were involved. Some CPAs go an extra step with their U.S. certified mail procedure and type the certified mail receipt number on the document being mailed. Considering that late filings continue to be a major source of malpractice claims, a review of your office procedures may help avoid losses and protect your reputation and goodwill.

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[1] Haaland v. Commissioner, T.C. Memo. 1984-335.
[2] Guerra v. Commissioner, T.C. Memo. 1983-21.
[3] Herrera v. Commissioner, T.C. Memo. 1984-47.
[4] Revenue Ruling 76-52.
[5] Espinoza v. Commissioner, 78 T.C. No. 28 (1982).
[6] IR 83-125.

SUMMARY OF THE IRS ATTACK ON TAX SHELTER PROMOTERS

- Amendments to Circular 230 provide that you are preparing a partial tax opinion where your projections are used in the selling effort. This requires you to ascertain that all IRS tax-opinion-letter standards are met.
- IRC § 6700 penalty of greater of $1,000 or 20 percent of the gross income on one organizing or participating in the sale of an entity who makes a gross overstatement or a statement with "reasons to know" of falsity.
- IRS Civil injunctive power under IRC § 7408 to enjoin conduct subject to penalty under § 6700 (promoting abusive tax shelters) or § 6701 (civil penalty for aiding and assisting).
- IRC § 6111 requires registration with Secretary of tax shelters defined as involving a tax shelter ratio of greater than 2 to 1 (ratio = cumulative deductions and 200 percent of credits to investment base at close of each of first five years after first offered for sale) where
  (i) registration required under federal or state law
  (ii) exempt by virtue of filing a notice with federal or state agency
  (iii) aggregate offering exceeds $250,000
  The Secretary assigns each shelter an ID number which must be furnished to investors and included on the tax return of each investor.
- IRC § 6112 requires organizers of shelters registered under § 6111 to keep list of investors available for inspection.
- IRC § 461(i) prohibits cash basis tax shelters from deducting any expenses for property or services prior to the use of the property or the provision of the service. There is an exception if performance occurs within ninety days after the close of the tax year. Deductions under this exception are limited to a partner's cash basis.
- IRC § 195 requires capitalization of all pre-opening (start-up) expenses except tax, interest, and research and development.

SUMMARY OF THE IRS ATTACK ON TAX SHELTER INVESTORS

- IRC § 6661 provides a substantial underpayment penalty of 10 percent of any substantial underpayment. To defend tax shelter items, the taxpayer must show that he reasonably believed "more likely than not he had the correct tax treatment." For nonshelter may defend by showing either disclosure or substantial authority. Disclose specified items pursuant to Rev. Proc. 84-19.
- Pre-filing notifications per Rev. Proc. 83-78 were upheld in *Mid-South Music*, 83-2 USTC ¶ 9710 (M.D. Tenn. 1983).
- IRC § 6621(d) provides for interest at 120 percent of the regular rate for "tax motivated transactions." This covers only underpayments exceeding $1,000 resulting from
  - Any valuation overstatement under § 6659(c)
  - Any loss disallowed by § 46(c)(8)
  - Any straddle under § 1092(c)
  - Any accounting method prohibited by regulations

TAX REFORM ACT OF 1984 CREATES NEW PROBLEMS

Under TRA '84 your clients can take no tax deduction nor credit where they fail to keep "adequate contemporaneous records" for "listed property" including autos, other property used for transportation, and home computers not located in a qualified home office. For autos this requires logs recording the date of each trip, mileage driven, and business purpose.

Suppose the bookkeeper says "Do you know our people have not been keeping those auto logs?" This means that you cannot allow the deduction because for taxable years starting after 1984 you must obtain written confirmation from the taxpayer that substantiation requirements were met. There presumably can be no reconstruction of contemporaneous records except as indicated by this excerpt from the conference committee agreement:

> If...these records are lost due to circumstances beyond the taxpayer's control, such as in a fire, flood, or earthquake, the conferees intend that the taxpayers continue to have the ability, as they do under present law, to substantiate a deduction by reasonable reconstruction of expenditures.

IRC § 6653(h) imposes a 5 percent negligence penalty on taxpayers who take deductions or credits without having the required substantiation. Signing a return knowing the taxpayer certification is false may be a felony for "aiding and assisting." Don't suggest firing the bookkeeper since this may result in a successful suit for wrongful discharge for firing a person who simply wants to comply with the law.

The old procedure was to set up a receivable on corporate books for the nondeductible items. However, under existing case law, the entire amount of an advance is a dividend unless there was intent to pay it back at the time of the transaction. This means following a regular repayment schedule. The courts are split as to the adequacy of repayment with salary credits.

The new law has thrown a new wrinkle into the receivable treatment. For shareholder below-market-interest loans, interest must now be calculated at statutory rates and this is income to the lender and a nonbusiness itemized deduction to the shareholder. If the shareholder itemizes, the combined effect for this portion is a wash. However, the *interest must also be treated as a dividend by the corporation and dividend income to the shareholder*. This is not a wash and results in more income tax for the shareholders.

If you have not explained these new rules to your clients, now is the time to do so in order to avoid some tough problems during tax filing for 1985.

SELECTING LIMITS *(continued from page 1)*

Transaction Totals

What is the largest dollar amount of checks your clients will write over a few years? What portion of this could be embezzled or based on fraudulent transactions without detection and yet be deemed by the courts to be your responsibility? Defalcation claims occur in both audit and nonaudit situations. Smaller clients are particularly subject to internal control problems. Where you supervise the bookkeeping operation, your exposure can be significant.

Investment Dollars

We are starting to see more claims based on investment advice especially in the tax shelter area. What is your firm's involvement in influencing investment dollars? You are particularly vulnerable if a tax shelter promoter is your client and your projections are used in marketing the offering. Does your firm handle client funds? You are personally liable for your partner's breach of trust!

Total Tax Benefits

Perhaps your practice is mostly limited to tax. This is the most numerous category of malpractice claims. How much tax plus penalties and interest could result from your defective tax advice? One CPA failed to file returns for a loss corporation so the statute of limitations ran on the loss carryforward. The result was a half million dollar loss.

Conclusion

Many CPAs still believe that $1 million sounds like a large amount of malpractice coverage. However, losses of $1 million are no longer unusual for the small local CPA firm. While no one can foresee the future and advise you as to the appropriate coverage, your exposure is much greater if you are heavily involved with investment advice and aggressive tax shelters or if your firm manages client funds. While audit work definitely increases risks, significant defalcation losses also occur in bookkeeping situations. Tax practice, especially tax advice, can result in losses that, if not insured, can devastate the small CPA.

Remember that it's too late to raise your policy limits after you know about a potential claim. The time to review your policy limits is now!

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TAX SEASON ISSUE