5-1985

Accountant's Liability Newsletter, Number 9, May 1985

Rollins Burdick Hunter Company

American Institute of Certified Public Accountants (AICPA)

AICPA accountant's liability newsletter

AICPA Professional Liability Plan

Number 9: May 1985

Accounting Practice Pointers

REPAIR OF AN ERROR IN YOUR TAX PRACTICE

There is very little in the professional literature on the subject of repair of errors in accounting practice. In the best managed practices, errors do occur with tax practice generating more malpractice claims than any other functional category. The purpose of this article is to provide an overview of repair of errors in your tax practice.[1] This subject is divided into:

- Notice to and negotiations with the client
- Notice to the IRS
- Overpayment of taxes
- Underpayment of taxes
- Tax advice

Notice to and Negotiations With Your Client

Whenever you discover an error in a tax matter, Circular 230 and AICPA *SRTP* §161.04 require you to notify the client.[2] However, be sure to notify your insurance carrier *before* discussing the problem with the client. Failure to give notice or admission of fault without the consent of the insurance carrier breaches your policy and voids your coverage. The companion article in this issue explains the procedure.

Where you handle the situation with poise, you can repair your error, retain the client, and enjoy more client confidence than you had before. We all make errors and most clients respect someone who demonstrates a willingness to rectify any wrong. After notice to the insurance carrier, your legal counsel may advise you to proceed to resolve a small matter with the client without making any mention of insurance. Unless instructed otherwise, always avoid any mention of insurance to the client or a money-hungry lawyer may smell a quick settlement. It is the opinion of U.S. Supreme Court Chief Justice Warren Burger that we have the costliest and most punitive system in the world for resolving civil disputes and he places the blame on the legal profession.[3]

(continued on next page)

FROM THE UNDERWRITER

Written by
Wayne Baliga
Claims Representative
L. W. Biegler Inc.

In the event that you learn of a claim or an occurrence that may lead to a claim, you can help us protect your firm by following these six steps:

1. Send all claim information directly to:
   L. W. Biegler Inc.
   100th Floor, Sears Tower
   233 South Wacker Drive
   Chicago, IL 60606

   L. W. Biegler is the managing general agent for the North River Insurance Company; and as such, we handle all claims under the AICPA Professional Liability Program. Do not send your claim to Rollins Burdick Hunter in New York or your personal insurance agent. They must forward your claim to L. W. Biegler, and the claims handling process will be delayed seven to ten days by not sending your claim directly to L. W. Biegler.
2. Include your *current* policy number in your initial correspondence to L. W. Biegler. Since your policy is a claims-made policy, claims can only be processed on current policies. Regardless of when the acts surrounding your claim arose, your current policy number will be the applicable policy.
3. The following information should be included when reporting a claim to our firm:
   A. A narrative statement including the facts and circumstances surrounding your claim. Include the dollar amount involved, and your assessment of your firm's liability in the matter.
   B. Indicate the specific services your firm performed for your client. Include a copy of the engagement letter and/or contract entered into with your client. If no engagement letter or contract was used, indicate this fact.

(continued on back page)

ROLLINS BURDICK HUNTER
605 Third Avenue
New York, N.Y.10158
Toll Free: 800-221-3023

REPAIR ERROR *(continued from first page)*

In some smaller cases it may be best to resolve the matter to the client's satisfaction in an informal matter so that no release is obtained. Any money that you pay or allowance that you make can be claimed as a setoff on damages. However, obtaining a release tends to dramatize the whole matter in the client's mind. In fact, lawyers have been disciplined in two cases for resolving errors with their clients and then obtaining a release of liability.[4]

Notice to the IRS

Since the CPA is ethically bound to notify the client of any error and the procedure to correct it, this presumably means recommending notification of the IRS. For example, you discover a potential personal-holding-company problem that you could have avoided by correctly advising the client to distribute earnings. Several questions arise:

- Must you notify the client of your error where the client has no knowledge of the situation?
- Must you advise the client to notify the IRS and pay the tax?
- As an independent expert called in to review such a situation, do you feel that it is in the client's interest to notify the IRS and pay the tax?

Despite the ethical guidelines, not all practitioners take the same approach on these questions. Major differences in approach may depend upon the particular factual situation and the materiality of it. Another consideration is whether the running of the statute of limitations will "cure" the error or if there will be a continuing problem related to basis or failure to file a required return.

In situations like this it is imperative to distinguish between notifying the IRS as to *past inadvertence* and knowingly claiming *current tax benefits* not justified by past conduct. Claiming current tax benefits to which the client is not entitled has the most serious potential consequences especially when motivated to avoid the CPA's malpractice liability:

- Criminal conduct for "aiding and assisting,"
- Punitive damages in a suit by a client who was uninformed and damaged by tax treatment motivated by a conflict of interest between the CPA and the client.

Overpayment of Taxes

Where an overpayment of taxes is your fault, the procedure is to file an amended return (claim for refund) on the three open years not barred by the statute of limitations. The IRS will generally pay interest from the date of overpayment to within thirty days of the refund check.[5] This should effect a complete repair for these years.

Where there is a net overpayment barred by the statute, you should explore the mitigation provisions of the Internal Revenue Code. Code sections 1311 to 1315 contain confusing and complex provisions that permit either the Commissioner or the taxpayer to reopen closed years to avoid an inconsistency between an open year and the closed year.[6] Code section 6521 provides for mitigation of the limitation period where there is an assessment of either FICA of self employment tax and a refund of the other.

If a refund of the overpaid taxes is barred, you are not *necessarily* liable for the overpaid taxes. In a California case the court held the CPAs were not liable where they followed the usual practice in San Francisco which was to assume that all payments covered by a W-2 were taxable income.[7] You do not guarantee the accuracy of a tax return. Liability is imposed only if your conduct fell below the average standard of care. If the overpayment is your responsibility, then you may be liable for interest on the money.

Underpayment of Taxes

Liability for Taxes. You do not pay the client's tax. Unless the incurrence of taxes resulted from your faulty tax advice, you are not liable for the taxes.

Liability for Interest. Since the client has had the use of the money, you should not be liable for interest assessed by the IRS on an underpayment. However, there is no clear judicial authority on this point. One court allowed recovery of interest without discussing the matter.[8] Unlike interest, underpayment penalty is not deductible due to IRC § 162(f) and Reg. 1.162-21. For this reason you may be liable for your client's tax rate times an underpayment penalty that resulted from your negligence.

Liability for Attorney's Fees. Under the American rule all parties pay their own attorneys' fees. However, you may be liable for the client's attorney's fee to resolve the problem with the IRS.[9] For this reason as

FOOTNOTES

[1] For a more extensive analysis see *The Tax Practitioner*, Accountant's Press, 1984.

[2] AICPA *SRTP* § 161.04 states "A CPA shall advise his client promptly upon learning of an error in a previously filed return. His advice should include a recommendation of the measures to be taken."

[3] In his 1984 address at the meeting of the American Bar Association, the Chief Justice said: "Our system is too costly, too painful, too destructive, too inefficient for a truly civilized people. To rely on the adversary process as the principal means of resolving conflicting claims is a mistake that must be corrected. No other nation allows the adversary system to dominate relationships to the extent we do."

[4] In the case of People v. Good, 576 P.2d 1020 (Colo. 1978), an attorney who tendered the client a refund check having a release in the form of an endorsement on the check was suspended from practice. In the case of The Florida Bar v. Nemec, 390 So. 2d 1190 (Fla. 1980), the court upheld reprimand of an attorney who obtained a release upon paying the amount of a settlement offer after the statute of limitations had run on the case.

[5] Where the overpayment results from a net operating loss, capital loss carryback, or credit carryback, interest runs only from the filing date of the claim for refund pursuant to IRS § 6611(f)(3)(B).

[6] Annot., "Correction of Errors in Barred Years," 54 A.L.R.2d 538 (1957); "Mitigation—Who Has the Last Laugh?", *Review of Taxation of Individuals*, Winter 1983.

[7] Lindner v. Barlow, Davis & Wood, 27 Cal. Rptr. 101 (Cal. App. 1963).

[8] Slaughter v. Roddie d/b/a Roddie Tax Service, 249 So. 2d 584 (La. App. 1971).

[9] Annot., "Attorneys' Fees Incurred in Litigation With Third Person as Damages in Action for Breach of Contract," 4 A.L.R.3d 270 (1965).

well as for client goodwill it pays to retain control of the adjustment process where possible so as to minimize costs.

Tax Advice

Where your tax advice proves faulty, you may be held liable for taxes or penalties that result. In a Louisiana case the CPA was held liable for taxes that resulted on a redemption of stock that the CPA advised would be nontaxable. However in another Louisiana case a tax attorney was held not liable when the advice proved defective. The difference was that the CPA's advice was clearly erroneous as a result of overlooking a provision of the Code; whereas, the attorney's advice was an informed judgment in a situation that lacked judicial precedent.

Summary and Conclusion

Where you handle the repair of an error with poise and confidence, it is possible to retain the client and in fact enhance client goodwill. Overpayment results in no liability for the three open years since an amended return will cure the error. In underpayment situations there is generally no liability for the tax that the client owed anyway. Tax advice deserves special caution because you can become liable for tax that would not have been incurred except for the error. Tax advice is more likely to result in liability where you fail to advise of general and specific risks of the proposed transaction.

NEWS REPORT

Nebraska: Favorable Management Letter Makes Auditor's Defense More Difficult; Audit Engagement Letter Proves Helpful

Where the auditor was sued by the client for damages resulting from an alleged delay in discovering fraudulent misstatement of inventory, the Supreme Court of Nebraska held that the client could introduce evidence that the auditor's prior management letter stated that internal controls presented no problem. It seems prudent to continuously advise all clients as to weaknesses in controls relative to comparable firms in the industry and possible improvements in control that may go beyond current standards. This can protect both you and the client while generating fees from MAS engagements.

This same case demonstrates the value of an engagement letter delineating the responsibility of the client and its officers and directors and the auditing firm. The court upheld this jury instruction over plaintiff's objections:

> Under the engagement agreement between the parties, and under Generally Accepted Auditing Standards, the defendant did not undertake to do a detailed fraud audit, or to disclose fraud or defalcations. The defendant must be aware of the possibility that fraud may exist in the plaintiff's company. However, an ordinary audit cannot be relied upon to assure that fraud or deliberate misrepresentations by plaintiff's management will be discovered. The defendant is not an insurer or guarantor if it turns out that fraud occurred and the defendant did not discover it. The defendant does have a responsibility for failing to detect fraud when such failure *clearly* results from the defendant's failure to comply with Generally Accepted Auditing Standards. The subsequent discovery of fraud does not of itself mean that the defendant's examination was negligently done.

Reference: Lincoln Grain, Inc. v. Coopers & Lybrand, 345 N.W. 2d 300 (Neb. 1984).

Florida: Court Apportions 80 Percent of Fault to Client

The comparative negligence doctrine adopted by most states requires apportioning damages between plaintiff and defendant according to relative fault. The Florida Court of Appeals applied Florida's comparative negligence rule and apportioned 80 percent of the fault for overstated receivables to the client and only 20 percent to the auditing firm. The client had relied to an unwarranted degree on the auditing firm and had failed to apply prudent management practices including monthly aging reports and internal controls over a new computer installation.

Reference: Devco Premium Finance Co. v. North River Insurance Co., 450 So. 2d 1216 (Fla. App. 1984).

Illinois: Auditor's Negligence Liability Limited to Third Parties That the Auditor Intended to Influence

When a third party sued an auditing firm for negligence, the Appellate Court of Illinois noted that the question of the duty of an accountant to a third party in Illinois was one of first impression. After reviewing the authorities, the court limited the scope of an auditor's third party negligence liability to persons the auditor intends to influence. In upholding dismissal of the suit the court held:

> In his complaint, however, plaintiff alleges Touche Ross had a duty extending to all potential investors in KPK Corporation as it was foreseeable KPK would submit the audit report to that class of persons. The complaint does not allege Touche Ross knew of plaintiff or that the report was to be used by KPK to influence plaintiff's purchase decision nor does it allege that the primary purpose and intent of the preparation of the report by Touche Ross [was] for KPK. Absent such allegations of fact, we find plaintiff's complaint insufficient to set forth a duty on the part of defendant to plaintiff.

Reference: Brumley v. Touche, Ross & Co., 463 N.E.2d 195 (Ill. App. 1984).

ANNOUNCING A NEW TEXT AND A NEW SERIES OF SEMINARS FOR "PROTECTING THE TAX PRACTITIONER"

This AICPA seminar features a new text and a new series of seminars to focus on IRS penalties and civil liability in your tax practice with related loss-prevention/risk-management procedures.

Date	Location	Telephone for Sponsoring State Society
May 21, 1985	Overland Park, Kansas	(913) 267-6460
May 22, 1985	Philadelphia, Pennsylvania	(215) 735-2635
May 29, 1985	New Haven, Connecticut	(203) 525-1153
May 30, 1985	Pittsburgh, Pennsylvania	(215) 735-2635
June 4, 1985	Orlando, Florida	(904) 878-8228
June 7, 1985	Miami, Florida	(904) 878-8228
June 25, 1985	Oklahoma City, Oklahoma	(405) 478-4484
June 28, 1985	Little Rock, Arkansas	(501) 664-8739
July 24, 1985	Altoona, Pennsylvania	(215) 735-2635
July 29, 1985	Flagstaff, Arizona	(602) 839-9942
August 9, 1985	Dallas, Texas	(214) 630-8900
September 13, 1985	Metro, D.C.	(202) 659-9183
September 9, 1985	Houston, Texas	(214) 630-8900
September 26, 1985	Columbus, Ohio	(614) 764-2727
October 4, 1985	Indianapolis, Indiana	(317) 872-5184
October 23, 1985	San Francisco, California	(415) 321-9545
October 24, 1985	Newport Beach, California	(415) 321-9545
October 25, 1985	Los Angeles, California	(415) 321-9545
November 1, 1985	Minneapolis, Minnesota	(612) 831-2707
November 7, 1985	Billings, Montana	(406) 442-7301
November 22, 1985	Knoxville, Tennessee	(615) 269-3478
November 26, 1985	Kansas City, Missouri	(314) 997-7966
December 11, 1985	Boston, Massachusetts	(617) 227-0196
December 13, 1985	Raleigh, North Carolina	(919) 782-2304
December 17, 1985	Denver, Colorado	(303) 773-2877
December 19, 1985	Chicago, Illinois	(312) 346-7957

Note: Each of these seminars carries eight hours of continuing professional education credit.

AICPA CPE HOT LINE

For further information about any of the seminars listed on this flyer, you can call the AICPA CPE General Information Hot Line Toll-Free:

1-800-242-7269

ANNOUNCING A NEW SERIES OF SEMINARS ON "AVOIDING MALPRACTICE PROBLEMS IN THE SMALL ACCOUNTING PRACTICE"

Some of these new AICPA seminars feature discussion leaders who are attorneys defending the AICPA professional liability insurance plan. Learn first hand from these attorneys how to apply loss-prevention/risk-management procedures in your accounting practice. Course materials include your copy of the hardbound reference work, *Duties and Liabilities of Public Accountants*. To enroll contact the sponsoring state society.

Date	Location	State Society Address/Phone
June 21, 1985	Boston, Massachusetts	Massachusetts Society of CPAS Three Center Plaza Boston, MA 02108 (617) 227-0196
June 26, 1985	Riverton, Wyoming	Wyoming Society of CPAS 1902 Thomes Ave., Ste. 201 Cheyenne, WY 82001 (307) 634-7039
June 28, 1985	Stamford, Connecticut	Connecticut Society of CPAS 179 Allyn St. Hartford, CT 06103 (203) 525-1153
August 1, 1985	San Francisco, California	California CPA Foundation 1000 Welch Road Palo Alto, CA 94304 (415) 321-9545
August 2, 1985	Los Angeles, California	California CPA Foundation 1000 Welch Road Palo Alto, CA 94304 (415) 321-9545
August 7, 1985	Chicago, Illinois	Illinois CPA Foundation 135 LaSalle St. Chicago, IL 60603-4197 (312) 346-7957
August 16, 1985	Metropolitan, D.C.	D.C. Institute of CPAS 2100 Penn. Ave., N.W., # 240 Washington, DC 20037 (202) 659-9183
August 28, 1985	Madison, Wisconsin	Wisconsin Institute of CPAS 180 N. Executive Drive Brookfield, WI 53005 (414) 785-0445
September 6, 1985	Buena Park, California	California CPA Foundation 1000 Welch Road Palo Alto, CA 94304 (415) 321-9545
October 9, 1985	Lanham, Maryland	Maryland Assoc. of CPAS 1205 York Rd., #30 Lutherville, MD 21093 (301) 296-6250

Note: Each of these seminars carries eight hours of continuing professional education credit.

UNDERWRITER *(continued from first page)*

C. Enclose any letters from your client or his attorney which pertain to the claim.
D. If the claim involves a tax matter, enclose all notices received by you or your client from the Internal Revenue Service.
E. If suit is filed, send the suit papers immediately to our office. When this is the case, you may wish to consider incurring the small extra expense of an express mail service. Our experience shows that these services are, of course, faster, and tend to be more reliable than normal channels.
F. The policy number, carrier, and coverage of any other insurance that may be applicable. This includes general liability policies, umbrella policies, fidelity bonds, or prior malpractice policies with other carriers that may have related to the work when it was performed.

4. Prior to hearing from an L. W. Biegler representative, do not admit any liability, or enter into any settlement negotiations with the claimant.
5. Your claim will be assigned a permanent claim file number by our office. It is imperative that this file number be referred to by you or your representative in all future communications to our office.
6. Retain this newsletter for your permanent file.

Unfortunately, as each year passes, malpractice allegations against accountants are occurring with greater frequency. Therefore, every firm should be prepared to take appropriate action upon learning of a claim or an occurrence that can lead to a claim. By following these six steps outlined in this newsletter, your claim will be handled promptly and properly by our company.

AICPA Professional Liability Insurance Plan Committee
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775