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Accountant's Liability Newsletter, Number 2, January 1983

Rollins Burdick Hunter Company

American Institute of Certified Public Accountants (AICPA)

ROLLINS BURDICK HUNTER

accountant's liability newsletter

AICPA Professional Liability Plan

Number 2: January 1983

Accounting Practice Pointers:
No. 2 of a Series

MANAGING THIS YEAR'S TAX PRACTICE FOR MORE PROFIT AND PLEASURE

Malpractice problems in the tax area have indicated a number of management procedures that can make your practice more profitable and pleasurable in this coming tax season. Here are a few of them.

Avoiding the April 15 Crunch

One CPA reports he was so busy and harried at April 15 that he really didn't have time to adequately consider the figures the client gave him when he was filing a huge number of requests for extensions. Then when the tax return was completed, there was a penalty for underpayment of tax because an extension is for filing and not for payment. The client said "I think you ought to pay that penalty."

The great majority of CPAs will never get into this situation because they avoid any April 15 crunch. Some CPAs establish a cut-off of April 1 and will accept no new tax-return clients after that date. Others have a postcard system and mail cards to all who do not come in early. The cards have boxes to check as to whether their return is already prepared or being prepared by others. One sole practitioner says that her engagement letter provides for a premium of $10 an hour where any essential data comes in after March 15. Some CPAs establish an advance closing date such as April 7 and act as if this date is April 15 and essentially prepare no returns after this date.

Many CPAs avoid extensions altogether. Some report that extensions would not exceed one per year in their practice and even then they require the client to sign it. One CPA reports that he has put together a kit so that clients who want to go the extension route can estimate the taxes that they want to pay when requesting the extension. The client is charged $15 for the kit.

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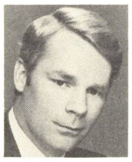
QUESTIONS AND ANSWERS CONCERNING INSURANCE COVERAGE FOR YOUR TAX PRACTICE



Written by William J. Crowe II
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If my practice is limited to tax returns and tax advice, should I consider the need for malpractice insurance coverage?

Yes. You have considerable exposure that most CPAs will want to insure. Tax practice generates far more claims than any other insured activity. Tax-return errors can make you liable for tax dollars plus penalties and interest where the errors are discovered after the three-year period for filing amended returns. Failure to file the client's Subchapter S election on time can result in liability for the resulting corporate tax. Tax advice can involve big exposure where it doesn't work out especially where you fail to advise of inherent risks and the possibility of a successful IRS challenge.

Is it necessary to give written notice pursuant to the policy where my only liability is for a $100 negligence penalty assessed on me by the IRS?

Your AICPA policy requires immediate written notice to L. W. Biegler Inc., 100th Floor—Sears Tower, 233 South Wacker Drive, Chicago, Illinois 60606 of any claim or of an incident or circumstance likely to give rise to a claim under the policy. If the only liability is $100 and this is within your deductible, the notice is not required. However, if you could incur liability to the client or others as a result of the incident or circumstances, you must give written notice

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Other CPAs advise clients as to a range of estimated tax and warn that the client is risking more penalties by paying smaller estimated tax and less penalties by paying more estimated tax. Still others give only high estimates.

One San Diego managing partner who talks about the quality of life says that his firm is now trying to limit the work-week to 50 hours in tax season. Weeding out clients who are of doubtful integrity or who no longer fit the firm's fee structure is an essential part of maintaining your quality of life. One CPA sends a letter to selected clients and indicates that the firm has changed its fee structure so that the fee for the coming tax year will be increased to a specified amount. At the bottom of the letter the client can check a box and his file will be transferred to a new CPA who is just starting out and who has the lower fee structure. Clients of doubtful integrity can be simply told that the firm is restricting the scope of its practice and now limiting its work to selected specialties. When new clients are interviewed, the prior four returns are reviewed for the tax preparer fees and the firm's fee structure is explained in terms of the checking and tax planning procedures so that new clients are fully aware of the range of fees that they should expect. Few CPAs do any tax returns for under $75.

The easiest way to make errors and to find yourself with malpractice claims is to let your tax practice get out of control so that you are tired and harried with an overwhelming April 15 crunch.

The Engagement Letter for Avoiding Claims and Collecting for Tax Work

Allowing yourself to develop collection problems leads to a strain in client relations generating claims for defective work as well as a drain on your cash flow. Good management practices can avoid these problems. Some CPAs send out a questionnaire or organizer with year-end tax planning hints in November or early December to individual tax-return clients. The end of the questionnaire contains the engagement letter provisions so that when the client signs the questionnaire, the CPA has an engagement letter for the current year's return. One Oregon CPA limits the scope of the engagement so as to avoid future misunderstanding with a clause that "I will prepare only the returns specifically stated above and will not prepare those unstated but required such as (but not limited to) your city licenses and personal property tax reports."

Where your clients leave the data at your office and you mail the returns to them, the signed engagement letter assumes more significance. If you fail to ask about substantiation for travel and entertainment, you will be assessed the $100 negligence penalty pursuant to Revenue Ruling 80-266. How can you ask this question if you never see the client? Some CPAs add a representation to this effect on the engagement letter/questionnaire that the client signs. It should also ask whether travel and entertainment has been previously disallowed since in this situation, the CPA must inspect the documentation to avoid the $100 penalty. While your firm may have handled the audit, the staff member involved may have since departed. Some CPAs put a flag in the file to show the date of a prior audit. Others include this as a memo on a carry-forward sheet included in their tax working papers.

The engagement letter can be used to avoid collection problems in particular situations. If the client has not paid for the prior year's return, the current year's engagement can be made conditional upon full payment for the prior year and an advance retainer expected to cover the current year. An increasing number of CPAs now specify interest on past-due fee balances. Clients with significant past balances for a variety of services can be put on an advance retainer basis for future services with an installment promissory note used to catch up old balances. Some CPAs report good results by turning the note over to the CPA's bank for collection or discounting it "with recourse" at the CPA's bank. The note provides for interest and payment of cost of collection including attorney's fees.

The tax engagement letter can be used to take care of other technical matters such as getting client consent for use of an outside computer service. It can also be used to educate and clarify for the client that:

1. tax deductions and positions on a return are always subject to IRS challenge and may result in IRS assessment which carries a presumption of correctness that must be rebutted by the taxpayer.
2. the CPA does not assume responsibility for such IRS assessments and representation of the client in connection with the audit or the assessment will result in additional charges for the CPA's services.

Avoiding Cash-on-Delivery Tax Returns

Some CPAs undertake selected individual returns on a cash-on-delivery basis. Because of potential problems, other options should be considered such as advance retainers for the estimated fee with any balance to be paid upon presentation of invoice.

If the taxpayer arrives at the CPA's office on April 15 without the money for the return, there is little option but to deliver the return. Unless a contract provides otherwise, time of payment is not of the essence and a few days delay is not a material breach. However, April 15 is of the essence. Refusing to supply the return may be a material breach for the CPA but not for the client.

Obtaining an extension is not recommended for several reasons:

1. It is not an economical approach to fee collection.
2. Any tax owing must be paid when requesting an extension.
3. Withholding records of a "books and records" nature for payment of fees is unethical under AICPA ethics ruling 501-1.
4. The IRS may challenge the delay of filing for this purpose.

A better approach used by some CPAs is to ask the client to sign a postdated check or a promissory note that carries interest and cost of collection.

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MANAGING TAX PRACTICE *(continued from page 2)*

Checklist for Your Tax Practice

To summarize the ideas we have discussed and to add a few others, consider the following checklist:

☐ Be sure to ask taxpayers if they have the required substantiation for travel and entertainment expenses they are claiming. Revenue Ruling 80-266 indicates that tax preparers who fail to ask taxpayers for such assurances will be subjected to the negligence penalty. Put this in writing on a questionnaire that the taxpayer signs. You are obligated to review the substantiation only where the IRS has found the taxpayer's previous assurances to you were not justified.

☐ Check for basis where there are losses from a Subchapter S corporation or "at risk" limits for deducting losses from tax shelters.

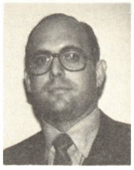
☐ Did we file an election for stepped-up basis pursuant to IRC sections 743(b) and 754 if there was a death of a member of a partnership? See *Chisholm v. Scott*, 527 P.2d 1300 (N.M. App. 1974) where the CPA was held not liable because the statute of limitations had run out on the malpractice suit.

☐ If we changed from an incorrect method to a correct method, did we get consent of the Secretary of the Treasury as required by IRC § 446(e)? See *Isaacson, Stolper & Co. v. Artisan's Savings Bank*, 330 A.2d 130 (Del. 1974) where CPA changed from a six-month lag in deducting interest expense but malpractice suit was barred by statute of limitations.

☐ Did we set up a receivable and disallow the tax deduction for personal expenses coming to our attention? See *Pickering v. United States*, 82-1 USTC ¶ 9375 (E.D. Ark. 1982), where the court sustained two $500 wilful penalties under IRC § 6694 because the tax return preparer told the bookkeeper "not to worry about it" when she pointed out repair bills, taxes, licenses, gasoline, and insurance for cars used by taxpayers' children and the weekly "salary" paid to a child who was away at college.

☐ Revenue Ruling 80-264 provides that overlooking a substantial minimum tax will not result in the 6694(a) tax preparer's penalty where it is the only error on the return and results from an oversight in reviewing a checklist requiring consideration of minimum tax.

LOOSE TAX ADVICE CAN BE DANGEROUS TO YOUR HEALTH



Written by H. James Cantwell,
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Tax advice is resulting in considerable exposure for your AICPA Professional Liability Insurance Plan. Here is a case study in point and some implications for your own accounting practice.

Case Study: IRC § 337 Liquidation

A CPA was engaged to advise concerning tax aspects of liquidation of a corporation. The corporation's only asset was an apartment house that was to be converted and sold as condominiums followed by liquidation of the corporation. The CPA suggested liquidation under IRC § 337 to avoid taxes to the corporation without warning of any risks inherent in tax advice and without warning that the IRS might consider the apartments as inventory. The IRS did take this position; inventory must be sold in bulk to one person to avoid the recognition of gain. The CPA incurred liability for the advice including an attorney's fee incurred by the client in the tax contest.

Implications for Your Practice: Advice versus Advocacy

The American Bar Association requires lawyers giving tax advice for investors to candidly evaluate each tax risk and give an overall evaluation (see ABA Opinion 346: *ABA Journal*, April 1982, p. 471). Surgeons must warn patients of risks of surgery. When giving tax advice, you should warn of both inherent risks in tax advice and the specific risks of the particular situation.

In complex situations involving unfamiliar ground consider whether you feel competent to research the matter and evaluate the relevant court decisions. Reputable tax specialists will assist you without taking your client.

QUESTIONS AND ANSWERS *(continued from page 1)*

including your name and policy number, the claimant, and the time, place, and circumstances of the act, error, or omission.

Do you have other questions?

I am as close as your telephone. Call me on our toll free line at 800-221-4722. I am pleased to quote representative rates and make arrangements to enroll you in the plan if you are not now covered. You can write me at Rollins Burdick Hunter Co., 605 Third Avenue, New York, New York 10158.

New Developments:

TEFRA ELIMINATES LIABILITY FOR CPAS WHO OBTAIN IRS' CERTIFICATE BEFORE RESPONDING TO IRS' SUMMONS

The Tax Equity and Fiscal Responsibility Act of 1982 makes it more difficult for taxpayers to stop a third-party recordkeeper from responding to an IRS summons. Amendments to Internal Revenue Code § 7609 require the IRS to give notice to the taxpayer within three days of service of a summons on a third-party recordkeeper but not later than 23 days before the date for production. Under the new law effective in 1983, taxpayers can stay compliance only by filing a petition to quash the summons in the appropriate federal district court within 20 days of receipt of the IRS' notice.

IRC § 7609(i) provides that the Secretary of the Treasury may issue a certificate to a third-party recordkeeper that the taxpayer has not filed a petition to quash or that the taxpayer consents. If you insist on this certificate prior to production, you are protected by IRC § 7609(i)(3) from any liability for production. It provides:

> Any third-party recordkeeper, or agent or employee thereof, making a disclosure of records pursuant to the section in good-faith reliance on the certificate of the Secretary or an order of a court requiring production of records shall not be liable to any customer or other person for such disclosure.

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SPECIAL TAX ISSUE