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accountant's liability newsletter

CERTIFIED PUBLIC ACCOUNTANTS

AICPA Professional Liability Plan

Number 3: May 1983

Accounting Practice Pointers: No. 3 of a Series

INCORPORATING YOUR PRACTICE

Many small CPA firms have incorporated their accounting practices while others are still considering this option. The same considerations that affect you also affect your physician and other professional clients. Here is a summary of some of the pros and cons.

Limited Liability

In most states the professional corporation provides limited liability. However, you remain personally liable to clients for the *professional* work that you personally perform or supervise. For example, in *Schnapp, Hochberg & Sommers v. Nislow*, 431 N.Y.S. 2d 324 (Sup. Ct. Queens Cty. 1980), the court held that dentists were *not* personally liable on a lease obligation that they signed on behalf of their corporate entity. Similarly in *Herkert v. Stauber*, 317 N.W.2d 834 (Wis. 1982), the court refused to impose personal liability on architects because their breach of contract did not involve professional services for architectural design or supervision of construction. In *Zagoria & Stoner, P.C. v. DuBoise Enterprises, Inc.*, 296 S.E. 20 353 (Ga. App. 1982) the court held that attorneys had met personal liability to *nonclient* recipients of dishonored checks drawn on the law corporation's escrow account.

Careful drafting of contracts is essential to avoid personal liability. Thus in *George William Hoffman & Co. v. Capital Services Co.*, 101 Ill. App. 3d 487 (Ill. App. 1981), the court imposed personal liability on a CPA because his professional corporation's contract to sell the accounting practice used the words he, him, his, and himself when referring to the obligation to consult and the covenant not to compete.

In a minority of states including Arizona, Colorado, Oregon and Wisconsin, incorporation of a professional practice may not result in limited liability. For example, the Oregon statute makes *all shareholders personally liable to all clients* of the professional corporation. This statute was construed in *Lungren v. Superior Court of Los Angeles County*, 168 Cal. Rptr. 717 (Cal. App. 1980), where a California court asserted

(continued on page 2)

LETTERS FROM READERS

Written by William J. Crowe II
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Here are some of your initial comments about our newsletter: "Super... Excellent... Thank you for your interest in our profession's problems... We can use it in staff training... Keep it up... Well written... Practical suggestions... I look forward to subsequent issues... Articles are of particular interest to us... Fills a gap in knowledge for most CPAs..."

Several readers asked questions that we will attempt to answer in this and succeeding issues. Here is one:

How about some information on "reservation of rights?"

When you notify L. W. Biegler Inc. (your plan underwriter) of a claim, you will probably be asked to furnish certain detailed information. If a suit has already been filed against you or is imminent, it may be necessary to arrange for your legal representation on an emergency basis. Many courts hold that when any insurance carrier undertakes an *unqualified* legal defense, that it is liable for all damages regardless of the coverage provided under the policy. For this reason it is standard procedure to undertake your defense while reserving rights to question coverage. Only after the facts and legal positions are fully developed can coverage questions be resolved.

Where any part of the claim against you may fall within the coverage of the policy, reasonable cost of your legal defense is covered. In some cases it is not possible to resolve the question of coverage until after trial. This usually occurs where there are several the-

(continued on page 4)

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This newsletter is published in cooperation with the AICPA Professional Liability Insurance Plan Committee to alert you to loss-prevention/risk-management considerations in your accounting practice. It should not be regarded as a complete analysis applicable to your particular situation nor used for decision making without first consulting your own firm's legal counsel. Furnished free to practice units insured under the AICPA Professional Liability Insurance Plan. Subscription information is available upon request. Copyright © 1983 by Rollins Burdick Hunter Co.

INCORPORATING PRACTICE *(continued from page 1)*

jurisdiction over a CPA practice incorporated in Oregon because a corporate officer came to California to prepare financials used in a merger of California companies. The court held that the Oregon statute *did provide limited liability* for a shareholder who did not participate in the work where the suit was filed by a nonclient third party.

Other Advantages

The corporation offers the small CPA firm several other advantages:

- Splitting of income with the corporation permits accumulation of capital for your computer and word processor at corporate tax rates as low as 15 percent.
- Corporate accident and health plans are deductible to the corporation but not income to the employee provided (1) they are not both self-insured and discriminatory and (2) there is no S corporation election.
- Loans from corporate pension plans are permissible while this option is not available for proprietors or partners because of IRC § 4975.
- Provided there is no S corporation election, the corporate fiscal year can be selected so as to defer income on individual calendar year returns.
- Provided the plan does not discriminate in favor of key employees, $50,000 of group term life insurance is deductible to the corporation but not income to the employee.
- Incorporation is necessary to take advantage of the spousal deduction under IRC § 221 for compensation paid for services performed for you by your spouse.
- The IRS may take the position that contractual payments to a retired partner are subject to FICA while this might be avoided by incorporating.

Disadvantages

Incorporating your practice has several clear disadvantages including:

- Higher FICA (almost $1,500 more per owner in 1983), unemployment tax, state franchise fees and taxes, and workers' compensation insurance.
- Accumulated earnings tax (see *Earnest Booth M.D., P.C.*, T.C. Memo. 1982-423, CCH Dec. 39,216 (M)).
- Personal holding company tax (Rev. Rul. 75-250, 1975-1 C. B. 172 indicates that where a CPA owns 100 percent of the stock of a corporation furnishing accounting services, the IRS will not assess personal holding company tax provided there are no contractual obligations requiring the shareholder/CPA to personally perform) (this problem is eliminated by electing S corporation status or diminished by paying out most of the income).
- Salaries may be reclassified as dividends by the IRS to reflect a return on capital investment.
- The IRS may attempt to reallocate corporate income (under *Foglesong v. Commissioner*, 691 F.2d 848 (7th Cir. 1982) the IRS will be unsuccessful where all business activities are funneled through the corporation).
- Failure to consider implications of corporate formalities may cause unanticipated problems (see *Kenneth A. Vindall D.D.S., P.C. v. Hoffman*, 651 P.2d 850 (Ariz. 1982), where the Arizona Supreme Court held that the Arizona statute *required* the professional corporation to purchase the stock of a shareholder who resigned from the corporate practice).

Conclusion

Starting in 1984 the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) has placed corporate and Keogh pension plans on a parity for purposes of deducting pension plan contributions; however, this is not resulting in liquidation of many professional corporations. Although TEFRA provided a transition rule whereby those liquidating professional corporations in 1983 and 1984 can avoid income tax on unrealized receivables, there may be other important income tax effects of liquidation. CPAs and other professionals may still want to incorporate in order to take advantage of accumulation of capital at lower corporate tax rates, tax-favored insurance programs, and loans from pension plans.

Because of a new provision (IRC § 269A), professional corporations that perform substantially all of their services for one other entity may be obliged to liquidate to avoid the threat of IRS reallocation of income. While limited liability is an advantage of incorporating in most states, this advantage can be negated by carrying adequate malpractice insurance and liability insurance on business property.

SHOULD REAL ESTATE OWNED FOR OFFICES BE TRANSFERRED TO THE PROFESSIONAL CORPORATION

Failure to transfer real estate owned for offices to the professional corporation leaves you personally liable as a landlord. For example, in *Lyon v. Barrett*, 445 A.2d 1153 (N. J. 1982), a legal secretary who fell on a stairway recovered both temporary and permanent workers' compensation benefits against her professional corporation employer. When she sued the lawyer *as owner of the building*, the court held that the immunity of the workers' compensation law that shielded the professional corporation did not extend to the owner who stood in a third party relation to the legal secretary.

On the other side of the coin, there may be valid reasons for *not* transferring real estate to the professional corporation. These include:

- Tax losses on the real estate may reduce permissible retirement contributions.
- The IRS may reclassify a portion of salaries as dividends representing a return on investment.
- Greater corporate investment makes admission of new stockholders more costly.
- Retiring shareholders may desire to retain an interest in the real estate while selling their interest in the professional corporation.

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Georgia, New Jersey, and Ohio Courts Embrace Foreseeability Rule for Negligence Liability to Third Parties.

In *Travelers Indemnity Co. v. Pullen & Co.*, 289 S.E.2d 792 (Ga. App. 1982), Travelers allegedly issued performance bonds in reliance upon audited financial statements of a contractor. After paying $50 million, Travelers sued the accounting firm on a negligence theory. In reversing summary judgment for the accountants, the court held that accountants owe a duty of due care to limited classes of persons known to be relying upon their representations.

In *H. Rosenblum, Inc. v. Adler*, 444 A.2d 66 (N.J. App. 1982), the court embraced the foreseeability rule as expressed in the *Restatement, Torts* 2d; however, the suit against the accounting firm was dismissed because a merger was not foreseeable when the accountants issued their report.

The Supreme Court of Ohio extended its foreseeability rule beyond the boundaries followed in most other jurisdictions with its decision of *Haddon View Investment Co. v. Coopers & Lybrand*, 70 Ohio St. 2d 154 (Ohio 1982). Despite the absence of any allegations that the accounting firm foresaw reliance, the court refused to dismiss a negligence complaint and held that accountants for a limited partnership can foresee reliance by future investors in the limited partnership.

Texas Cloaks Accounting Firm Serving as Expert Witness With Absolute Privilege Against Suit: Bailey v. Rogers, 631 S.W.2d 784 (Tex. App. 1982).

An accounting firm was sued for alleged negligence and bias in preparing its report as a court appointed witness. Summary judgment for the accounting firm was affirmed because in Texas any communication, oral or written, uttered or published in the course of a judicial proceeding is absolutely privileged and no action will lie despite falsity or malice.

Illinois Accountant-Client Privilege: Armour International Co. v. Worldwide Cosmetics, Inc. 689 F.2d 134 (7th Cir. 1982).

Where a suit in federal court was to be decided under Illinois law, the court held that the Illinois accountant-client privilege would govern. However, it was not applicable in the particular factual setting because (1) the audits had been performed in Japan by persons not licensed in Illinois and (2) the only contact with Illinois was the service of the subpoena on the accounting firm's Chicago office.

U. S. Supreme Court Expands Accountants' Liability Under Section 10(b) of the Exchange Act Herman & MacLean v. Huddleston, 103 S.Ct. 683 (1983).

Reversing a trend since its 1976 decision in *Ernst & Ernst v. Hochfelder* of narrowly limiting suits under federal securities laws, the U.S. Supreme Court has now taken an expansive view holding:

- An accounting firm can be sued under section 10(b) of the Exchange Act despite an express civil remedy under section 11 of the Securities Act.
- The standard of proof under section 10(b) is only "preponderance of the evidence" and not "clear and convincing" evidence as had been required by the Fifth Circuit.

Texas International Speedway, Inc. (TIS) sold over $4 million of securities in 1969 to finance construction of an automobile speedway. After bankruptcy in 1970 investors filed a class action suit against several participants in the offering including the accounting firm that had issued an opinion concerning certain financial statements and a pro forma balance sheet. It alleged a scheme to misrepresent or conceal the financial condition and costs of building the speedway.

After a jury verdict based on "preponderance of the evidence," judgment was entered for plaintiffs. The U.S. Court of Appeals for the Fifth Circuit reversed holding that the standard of proof was "clear and convincing" evidence as traditionally required in civil fraud actions at common law. In reversing the Fifth Circuit, the U.S. Supreme Court said:

> An important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common-law protections by establishing higher standards of conduct in the securities industry. The balance of the parties' interests in this case warrants use of the preponderance standard, which allows both parties to share the risk of error in roughly equal fashion.

Still further expanding federal remedies, the Court held that federal securities laws are cumulative so that the accounting firm could be sued under section 10(b) of the Exchange Act despite the provision of an express civil remedy under section 11 of the Securities Act.

Pennsylvania Accountant-Client Privilege: William T. Thompson Co. v. General Nutrition Corp., Inc. 671 F.2d 100 (3d Cir. 1982).

In rejecting the applicability of the Pennsylvania accountant-client privilege, the court held that a suit involving both federal and state claims was controlled by the federal rule favoring admissibility rather than the state acccountant-client privilege.

LETTERS *(continued from page 1)*

ories of suit or several items of damage and some of the theories or items are within the coverage while others may be excluded.

One element of damages not within your coverage is punitive damages designed to punish you for flagrant conduct. Your policy covers only "compensatory" damages. Competing policies generally exclude punitive damages. In a number of jurisdictions it is illegal to insure against punitive damages because it is considered contrary to public policy. Fortunately, punitive damages are not allowed in Louisiana, Massachusetts, Nebraska, Washington or Puerto Rico.

When you are entitled to a legal defense under your policy, you are entitled to an attorney of undivided loyalty. In some jurisdictions such as Illinois *(Maryland Casualty Co. v. Peppers*, 355 N.E.2d 24 (Ill. 1976)) and New York *(Rimar v. Continental Casualty Co.*, 376 N.Y.S.2d 309 (App. Div. 1975)), reservation of rights entitles you to select the attorney of your choice to control the litigation with reasonable costs borne by the insurance carrier.

Whenever you are entitled to a defense under your policy, L. W. Biegler Inc. undertakes to supply you with competent legal counsel of undivided loyalty to you. In some seventeen major centers there are law firms regularly designated by L. W. Biegler Inc. to defend CPAs. In remote or rural areas L. W. Biegler Inc. works with insured CPAs in selecting legal counsel. Many of our insureds report satisfaction that L. W. Biegler Inc. appointed their own attorney to defend under the policy. Other CPAs feel that their personal lawyer may not be sufficiently acquainted with accountant's professional responsibility. The important thing to remember is "Don't try to settle your own claim!" Call collect: L. W. Biegler Inc. (312) 876-3162 upon first learning of any occurrence that may give rise to a claim. Sometimes files are closed with no losses.

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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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