

## Risk Management Tips for Tax Practitioners

For CPAs operating their own firm, tax practice continues to be a key source of revenue. While tax return preparation is still complex, the sophistication of readily available tax preparation software has both simplified and expedited the process.

Why then do more than 50% of all claims made against practitioners insured with the AICPA Professional Liability Insurance Program arise from tax engagement, and how can such claims be avoided?

Nearly half of all tax claims presented against AICPA Program policyholders allege arithmetic or filing errors. Some basic but important techniques can help practitioners avoid these types of claims.

Double check all computations prior to inputting data. Though simple and obvious, this step is often overlooked in an effort to save time. Do not rely on your client's arithmetic, even if a tax organizer has been used.

- Compare current year income, deductions and tax treatment to the prior year's return. A cursory review should reveal any significant changes. If the documentation provided by the client (e.g. W-2s, receipts, property tax bills) does not indicate obvious reasons for changes noted, ask the client about the change to determine if further investigation is required.
- Utilize existing quality controls built into tax preparation software. Do not override edit functions designed to check for errors. Doing so deprives you of a tireless second reviewer.
- Utilize a staff member or a practitioner from another firm to spot check your work. If you use a practitioner outside of your firm, carefully protect client confidentiality. The most common type of filing error is failure to file on a timely basis or failure to file for an extension of time.
- Using your diary system, adhere to strict internal deadlines for receiving client information necessary to complete your work and for processing returns. Your engagement letters and any follow-up letters to clients should note both your internal deadlines and IRS filing deadlines. If an extension of time must be requested, the application should be sent to your client with a dated cover letter explaining the need to file for an extension, the IRS deadline date to apply for an extension, and noting that underpayment and late payment penalties and interest may apply. The letter should clearly state that the client is responsible for signing and mailing the application for extension to the IRS on a timely basis.
- Don't assume that your client's filing status is unchanged unless you have clearly assigned to the client in an engagement letter the responsibility for determining status. If making a recommendation regarding filing status is part of your engagement, document and date all discussions with your client regarding this issue in your work paper file. Note any change in status in the engagement letter and/or the transmittal letter that accompanies the completed returns.

In 30% of all tax claims against AICPA Program policyholders, the claim alleges that an election error was made. These claims primarily arise in connection with the preparation of corporate tax returns for closely held businesses. The three most common election error allegations involve S corporation status, NOL carrybacks, and like-kind exchanges.

Owners of small corporations usually have a limited understanding of the tax impact of these elections. Often, they have heard about the ability to make such an election from a business associate, and are interested in obtaining the tax savings they heard about. Providing off the cuff advice in this area or in any area that requires consideration of the client's specific situation is a recipe for trouble. A practitioner should carefully research the client's circumstances and the tax rules and regulations, and explain to the client (preferably in writing) the respective benefits and drawbacks of these elections.

If the client is preparing to incorporate its business or a subsidiary, you should also advise it to consider the effect of incorporation on tax status prior to proceeding. Lack of communication between the client, its attorney, and its CPA regarding the consequences of a business transaction is a common problem leading to claims. You need to remind your clients that business transactions have legal, tax, and accounting implications, and that their interests are best served by discussing these issues with both the attorney and you prior to making a decision.

- Discussions with clients should be followed by a letter confirming that these issues were discussed, noting requirements to qualify for an election, deadlines for making or terminating an election, and most importantly, noting that decisions on whether or not to use the election must be made by the client - not you.

Nearly 15% of all tax claims against AICPA Program policyholders arise from engagement scope disputes. Often an income tax return preparation client may seek to lay blame on the CPA when faced with a tax liability that could have been mitigated or avoided through appropriate tax planning. Additionally, business income tax return preparation clients faced with unplanned sales tax, use tax, or occupancy tax liabilities may claim that preparing these returns was the responsibility of the CPA. This problem can best be addressed by issuing engagement letters, clearly delineating the scope of the engagement and the fact that additional services are available at an additional fee. Avoid using automatically renewable engagement letters, even if the engagement remains unchanged from year to year. Consider the fact that in litigating this type of dispute, jurors are forced to rely on the credibility of the parties' testimony in the absence of relevant and timely written documentation which shows the scope of the engagement.

The keys to risk management for tax practitioners are best summarized as:

- Maintain a system of quality controls that include appropriate training and supervision, and do not bypass your own procedures in the interest of saving time.
- Ensure that you and your client have a mutual understanding of the scope of your engagement, and tax issues discussed, and the individual responsibilities of both parties.
- Issue engagement letters whenever possible, and document all discussions with the client both in your work paper file and in a letter to the client.

-By Joseph Wolfe, Director of Risk Management, Accountants Professional Liability, CNA Pro.

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