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# Responsibilities in Tax Practice

by Neil R. Bersch

The author's remarks are based on his participation as a member of the Tax Division of the American Institute of Certified Public Accountants and its Committee on Responsibilities in Tax Practice. As such, they are based on the feelings and experiences of many tax practitioners.

Your responsibilities in tax practice include a responsibility to the firm, to your client and to the Internal Revenue Service, as well as to yourself. By now you are familiar with the five Responsibilities Statements issued by the Tax Division of the American Institute of Certified Public Accountants. These statements discuss such things as when you should sign a return, use of estimates in tax return preparation, and other responsibilities.

You may be wondering why there have been only five Responsibilities Statements issued by a committee that has been functioning for over eight years—that deserves some explanation. The committee has very carefully considered every proposed responsibility statement. They have taken their assignment seriously and, before issuance, each proposed statement receives careful scrutiny by the committee members individually and as a whole; scrutiny not only as to the substance but also the precise wording. This has resulted in as many as 28 or 29

drafts of a proposed statement and three to four years in the development. The committee is presently working on three more proposed Responsibility Statements that I want to discuss because of their significance in terms of tax practice today.

## **Advice to clients**

The first one deals with the question of Advice to Clients. It originally started out as "Follow-up on Advice to Clients." But after rehashing this several times, there were a lot of people who said, "We're not sure we have any responsibility to follow up or update advice previously given to clients so let's eliminate any inference in the title to 'Follow-up'."

What happens when you give written or oral advice to a client on a particular matter and subsequently the code or regulations change or a case is decided which is contradictory to the position that you have taken? Do you have the responsibility to get in touch with your client? And if you have the responsibility, for how long do you have it; an hour, a week, a day, a month, a year? Does it make any difference whether the advice was oral or written? Let me give you an example of a very disturbing actual instance which occurred in a reported case.





A CPA had a relationship with his client that covered a period of seventeen years. The client came to him one day and said, "I would like to eliminate corporation A which I own and I would like to do it through the vehicle of my other company, corporation B." The CPA advised the client to have corporation B purchase all of his stock in corporation A for cash. This was a few months after the enactment of Section 304 with which the CPA was unfamiliar. The client went through the transaction on the advice of his CPA (in contravention of Section 304) and the transaction was never investigated by Internal Revenue. Approximately two years later, without rechecking with the CPA, he relied upon the advice previously rendered and duplicated the transaction with two other controlled corporations. This time he got caught. After paying the deficiency, the client sued his accountant for erroneous advice and won.

Obviously, this is not identical to the situation where you give advice to a client which is *correct* advice at the time given but then something changes and the advice is no longer valid. But if you look at the dicta of the court in this case, it is very disturbing. The court noted the seventeen-year relationship between the CPA and his client and also that the client relied upon his accountant in tax matters. When the client asked his CPA for advice, he expected it to be accurate, he expected it to be reliable, and he expected the CPA to advise him if this was not the case. It is not beyond belief to consider that the court might have ruled in the same manner even if Section 304 had been enacted after the first transaction.

Does your responsibility to follow up depend on the amount involved? Does it depend on the nature of the question that was raised as to whether it is complex, simple, unusual; or does it depend on how imminent the transaction is?

What about the nature of the publicity the problem has received? If you tell the client something and then Congress passes the 1969 Tax Reform Act and it's in all the newspapers, is your responsibility lessened? Does it make any difference as to the nature of the client—whether he is sophisticated with his own tax department or an unsophisticated individual who doesn't know anything about taxes?

Does your responsibility to follow up depend upon your relationship with the client? How many years have you known him; how many times has he said to you, "I count on you, Joe?" Does it make any difference with respect to the nature of the engagement? For example,

if you complete a foreign tax study for a company and you say, "this is how you should operate abroad," and now the foreign or domestic tax laws change and the client continues to rely on your original advice, do you have a greater obligation here (since you have set operating policy for him) to tell him the rules have changed? Is your responsibility different in a one-shot situation on a merger of company A and company B?

Does it make any difference whether the advice was rendered to a former client as compared to a current client? All of the above questions must be dealt with and considered.

For a long time the committee has been discussing the question of whether a limiting paragraph or a caveat at the end of every opinion letter or at the end of every telephone conversation, if you want to bring it down to that level, is necessary. The caveat would state, in substance, "This is how it is today but you know the tax laws are in a constant state of flux and our opinion is valid only for this moment." Would such a caveat limit your liability, if any, to follow up? Or is the business community so knowledgeable about the flexibility and changing nature of the tax law that they've already assumed this and the caveat is unnecessary? Now you don't have to be as bold as I indicated and insert a paragraph at the end of every letter just as is done in audit opinions; but under some circumstances you may wish to use phraseology somewhere in the letter so that the client will clearly understand that your opinion or advice is based on recorded cases and other material as of the date of the letter.

The portion of the draft dealing with the caveat currently reads as follows:

"Some CPAs use precautionary language to the effect that their advice is based on facts as stated and authorities which are subject to change. Although routine use of such precautionary language seems unnecessary based on accepted business norms and professional relationships, the CPA may follow this procedure in situations he deems appropriate."

There are some really knotty questions to contend with before a statement of this type is ever issued, such as: Does the issuance of a statement of this type indicating that you have some responsibility, increase or decrease your potential liability? If the responsibility statement is issued today and if a caveat is advised, have you accepted greater liability for all the advice you have given in the past in which you have not inserted such a limiting paragraph? Let's assume that no responsibility state-



ment should be issued and no responsibility currently exists to follow up on advice previously rendered. Is that proper? Should the profession now undertake to assume some responsibility? Would CPAs be at a disadvantage with our brethren in the legal field? They also give opinions on roughly the same type of subjects as we do.

Below are some brief excerpts from the draft of the Responsibility Statement as it stands at the present time. This statement is presently at the executive committee level of the American Institute Tax Division. As it stands today, here are some of the key phrases:

“The CPA may communicate with his client when subsequent developments affect advice previously provided with respect to significant matters. However, he cannot be expected to have assumed responsibility for initiating such communication except while he is assisting a client in implementing procedures or plans associated with the advice provided.”

That is not meant to hold the CPA to follow up in those areas where he has set up a plan and then completed the plan. But it will hold him to the responsibility of updating his advice during the implementation period of a plan which he has suggested.

“Though written communications will vary to meet particular requirements, they may include the following:

1. A statement of the pertinent facts as understood by the CPA.
2. A statement of the problem or issue under consideration.
3. A summary of authorities relevant to the subject under consideration.
4. A conclusion or recommendation with such qualifications as are necessary.”

I think you will recognize those suggestions as precisely the type that the Internal Revenue Service places in a ruling when they issue it. Our firm issues annually a number of opinion letters and they should all include, as a minimum, the recommendations stated above.

Let me give you an example of an actual situation wherein the above procedural suggestions were not followed:

A client called and asked if he merged corporations A & B, what would be the tax consequences? A four-page letter was written on the tax consequences of the merger; it was reviewed and submitted to the client. Two weeks later he called the CPA and said, “How shall I invest the cash I received in the deal?” The CPA said, “What cash?” The client replied, “Don’t you re-

member, ‘A’ company acquired ‘B’ company, which I owned, for cash; we then merged them, and you fellows gave me an opinion on the tax consequences of the merger.”

To the horror of the CPA, it now became clear that his letter, while technically accurate, did not apply to the situation originally posed by the client. The meaning attached to language used by a layman does not necessarily have the same meaning to us when we are using it in a technical sense. If the CPA had stated all the facts as he knew them and as they had been represented to him, he would not have been in the position of issuing a letter which was completely erroneous, based on the fact situation.

### **The treatment of error in a tax return or in an administrative proceeding**

There are two other Responsibility Statements that are currently under examination dealing with the question of error. One deals with the question of error in the preparation of a tax return and the other deals with the question of error in an administrative proceeding. Error can be defined as something “lacking reasonable support.” I’m not talking about things that are “grey;” I am talking about things that are clearly “black” or “white;” clearly wrong; clearly in error. This definition should be kept in mind.

What happens in a situation where a client has failed to file a return at all and you become aware of this? What happens if there is an error in a return previously filed that you are aware of or an error in a return that is currently being filed; and, what happens when you are representing a client before the Internal Revenue Service and you suddenly discover that there is an error in the return? What are your responsibilities?

Tentatively, the committee has reached several conclusions:

1. As soon as you learn of the error, you are under the responsibility to advise your client promptly and indicate a course of action. The indication of the course of action could be oral or written. The CPA *cannot* inform the Internal Revenue Service without the client’s permission. That would be a violation of his client relationship. This rule is clearly stated in Treasury Circular 230.
2. If the CPA is going to prepare the current return and the client has refused to take action with respect to the correction of an error on a prior return, he should consider whether or not to proceed with the



preparation of the current year's return, (where there was a material understatement of tax in the past). If the CPA decides to prepare the current year's return, he must be absolutely sure that the error is not repeated or not allowed to reduce the current year's tax or otherwise influence the income. This rule might not apply, however, where the tax was understated in the past and the current year's treatment allows the client to catch up and become even with the board. Due note should be taken, however, of any statute-of-limitations provisions.

3. When you're dealing with the Internal Revenue Service and you find an error in the return (and it doesn't have to be in the same issue that's under discussion with the Service), again you are required to request the client to allow you to disclose the error. If he refuses, the statement draft provides that it is "preferred practice" that you withdraw from the engagement if your continued representation of the client will mislead the Internal Revenue Service.

Now, everybody's proud of his reputation. Everybody's proud of the fact that when a Revenue agent comes in and you've dealt with him before, he says, "When you tell me something, Joe, I know it's o.k. and I believe you. I don't have to look at the documents. I know you wouldn't mislead me." How many of you have been involved in that situation? I'm sure it happens all the time. That is a *tremendous* responsibility. Because, if there is an error in that return—a patent error—your very act of representing the client adds credibility to the return and could be misleading to the Revenue agent.

Against the act of withdrawal, if the client refuses to allow you to disclose the error, you must consider a possible violation of your confidential client relationship. If the very act of withdrawal will clearly constitute a violation of your confidential relationship with the client, then you may not withdraw. In fact, the Code of Professional Ethics bars you from withdrawing. At what point in time does your withdrawal constitute a violation of your confidential relationship with the client and at what point in time does your representation constitute misleading the Internal Revenue Service? These are obviously some very difficult questions with which to deal.

Both of these Responsibilities Statements on the question of error are currently out to the Executive Committee of the American Institute Tax Division for vote and again we should soon have some information as to the reasonableness of issuing them in the near future.

## Other responsibility statements

There are a couple of other Responsibilities Statements that are also being considered by the committee. I won't discuss them in too much detail except to give you an idea of some of the things that are being considered. One of them involves the jurat or potential variations in the jurat. Under what circumstances do you not sign a tax return or seek to modify or change the jurat to fit particular circumstances?

The question was originally raised because certain CPAs were *modifying the jurat* by adding "prepared from the books without audit" or "prepared from information furnished by the taxpayer."

The committee has concluded that these modifications are not acceptable and unnecessary because the jurat talks about things which are "true, complete and correct" *to the extent of your knowledge*. However, there are other more significant areas where some people have felt at times that it was necessary to modify the jurat. Let me give you a few examples:

First of all, the definitions of the words on the jurat are extremely important. True, correct and complete. *Complete* means, "possessing all necessary parts," and that really hasn't given too many people a problem. *Correct* has been defined as, "conforming to an approved or conventional standard" and that doesn't seem to create much of a problem either. The word *true*, on the other hand, is very troublesome. It's defined as "in accordance with the actual state of affairs." Let me give you a few examples:

Several years ago a taxpayer walked into a CPA's office with several shoe boxes. He said, "I haven't filed a return in five years. I'm involved in doing business as a consultant individually and as an employee of my corporation. I can't tell which records are mine, which income is mine, which expense is mine and which belongs to the corporation; do the best you can." So the CPA sat down with the client and after a very substantial period of time came up with figures that produced a reasonable position but could hardly be called "in accordance with the actual state of affairs." The CPA did not feel he could sign the jurat and he therefore attached a statement to each return which effectively said, "Look, here's what happened; we did the best we could, if you want to examine the returns, come in and take a look at it and we'll work it out." Of course the Service audited the returns and a settlement was ultimately achieved.



Under the current position of the Responsibilities Committee, you have two choices; you sign the jurat or you don't prepare the return. If you want to put in a disclosure statement after signing the jurat, that would certainly be appropriate. The decision that you must reach is at what point do you sign the jurat indicating the return is "true" and then attach a statement in the back saying "I really don't know whether it's true or not" (which is actually the fact)?

And now, a more difficult problem:

A taxpayer who had acquired the stock of an unrelated company for cash was advised by his attorney that the transaction qualified as a reorganization under a specific state statute. (This was apparently an innovative move on the part of the attorney and had some very favorable legal and business ramifications.) From a tax standpoint, the CPA felt it was clearly a "purchase" and not a reorganization. The attorney advised the client that he was entitled taxwise to both a step-up in basis of the assets and also to the carry-over of the net operating losses of the acquired company. When asked why he felt that way, he said the issue had never been decided by the Supreme Court!

This was a most frustrating and difficult situation for the CPA. To make a long story short, the CPA firm had to decide whether or not they would sign the return under the circumstances dictated by the attorney. A page and a half "Disclosure of the Transaction" was prepared by counsel to his satisfaction and was approved by the CPA. It was placed in the return. The CPA then signed the return as being true, complete and correct. At that point in time, he wrestled with the question of saying on page one "It is true," and on page 6 saying "It isn't." After working on the Responsibilities Committee for the last two years, I am convinced that the CPA was wrong. He should not have signed the return.

What about the situation where a client deducts political contributions or personal expenses in violation of the code? He says, "I don't care what you say on the return. Put all the disclosure you want in there, just sign it." Is that sufficient? Believe it or not there are two schools of thought on the subject. One school says you can sign anything as long as you disclose it and another school of thought says, if it's wrong, you don't sign it.

Wrong is wrong. The Committee currently sympathizes with the line of the second philosophy; regardless of how you disclose it, if it's wrong, that's the end of it. You probably should refuse to sign the return.

Now before I close, I would like to tell you about some of the other problems with which the Committee is concerned and may decide to study formally.

1. At what point must a CPA recommend legal counsel? Where does his responsibility stop and where does counsel's responsibility begin?
2. What's the responsibility of a CPA to settle a case at the lowest level?
3. Is there a difference between tax ethics and morals? Think about that one. It's a very deep and disturbing question.
4. What is your financial responsibility for error? What happens when you do make a mistake?
5. What's your responsibility to suggest or participate in the legislative process?
6. What is your responsibility if the Internal Revenue Service's administration of the regulations is loose? Section 274 is a perfect example. In a sampling of some CPA firms, a few years ago, concerning the use of the Cohan Rule (where the IRS was approaching it differently in various parts of the country), the following comments were received. One firm said that if the IRS is relaxing (unofficially) the rule—that's what we do! Another said, just because they're relaxing, it does not reduce our responsibility. We still must follow the regulations under Section 274. Obviously, this is a matter that must be dealt with.
7. What is the responsibility that you undertake when you are using an outside computer or processing facility?
8. What does the concept of materiality mean in the tax area? This would be a most difficult assignment.

All these are deep penetrating questions with no "pat" answer for any one of them. The profession must pursue these questions and keep seeking the proper answers. As a final word, let me suggest that while our profession is rewarding, you must be very careful of your responsibilities and you must be very cognizant of the fact that this is a very risky business in which we find ourselves.