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Documentation is your ally for tax and other services

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It was time for year-end tax planning with a successful, cash-basis law firm that was having an exceptionally good year. Since bonuses would not be paid out until March, the tax bite was expected to be significant. The CPA firm partner and the law firm CFO discussed the amount of tax that would be due, and the CFO asked if changing to the accrual basis of accounting would defer tax. The partner noted that, generally, this accelerated income and related taxes, but a calculation could be completed to determine the precise impact.

The tax manager performed the calculation and determined that applying the accrual method, instead of the cash method, reduced the law firm's taxable income for that year, notwithstanding the change of accounting method. The CPA and the CFO discussed the analysis in depth, and the CFO elected to change to the accrual basis of accounting. Several years later, the CFO retired, and a new CFO was hired.

After reviewing prior-year tax returns, the new CFO asserted the CPA firm incorrectly advised the law firm to change to the accrual method of accounting. Although the law firm saved money in the year of the change, several hundred thousand dollars of additional tax was paid in the following years, largely due to marginal profits. The new CFO alleged that the CPA should have analyzed the tax impact of the accounting method change on both highly and marginally profitable years to understand its overall effect. The lawsuit against the CPA firm sought recovery of the law firm's costs to borrow money at high interest rates to pay the additional tax.

Discovery revealed that the CPA, who was now permanently disabled due to dementia, inadequately documented calculations and discussions related to the change of accounting method. In addition, the tax manager had left the firm and could not be located.

With nobody available to testify regarding discussions with the prior CFO and inadequate documentation to support the change of accounting method, the case was settled.

This fictitious scenario illustrates how documentation represents a key risk management recommendation for all services provided by CPA firms, including tax. In fact, the importance of proper documentation is reflected in both the AICPA Statements on Standards for Tax Services (SSTSs) and Treasury Circular 230, *Regulations Governing Practice Before the Internal Revenue Service* (31 C.F.R. Part 10). This column discusses the requirements of both, other recommendations, and how client discussions may be appropriately documented.

PROFESSIONAL GUIDANCE FROM THE AICPA AND IRS

SSTS No. 7, *Form and Content of Advice to Taxpayers*, addresses the CPA's responsibilities to communicate tax advice to clients. To a great extent, SSTS No. 7 asks the CPA to exercise judgment in documenting advice. Paragraph 6 states that "written communications are recommended in important, unusual, substantial dollar value, or complicated transactions." Paragraph 7 provides examples of several considerations (see "SSTS No. 7, Paragraph 7").

Circular 230, Section 10.37, *Requirements for Written Advice*, requires the practitioner to consider all relevant facts and assumptions and apply the law and authorities (see "Circular 230, Section 10.37, *Requirements for Written Advice*").

OTHER RISK MANAGEMENT RECOMMENDATIONS

Circular 230 and SSTS No. 7 are valuable tools for producing a formal, written tax memorandum. The following information should also be considered:

- The client's sophistication regarding tax and accounting matters;
- Recommendations and alternatives, if any;
- A disclaimer that the CPA firm is not responsible for updating the advice if guidance changes; and
- Responsibility for implementation lies with the client, not the CPA.

Moreover, although Circular 230 only applies to federal tax advice, this process is beneficial for all advice, including advice related to state, local, and international matters or even nontax matters.

OTHER WRITTEN DOCUMENTATION

Although defense counsel would prefer a written tax memorandum for any advice, practitioners realize this protocol may not be practical and must use professional judgment when determining the degree of documentation required. If comprehensive research is performed, a formal written tax memorandum should be produced. However, for less formal discussions, a note to the file may be sufficient, especially for general advice. Correspondence to the client is generally beneficial and especially important with respect to confirming client-specific advice.

Documentation for client discussions, regardless of format, should include:

- Discussion participants;
- Date, time, and location of discussion;
- Information provided;
- Client feedback;
- CPA response to client feedback;
- Additional work/research to be done, if any; and
- Conclusions, if any.

APPLICATION TO THE CLAIM SCENARIO

In the example, the CFO and the CPA presumably had several discussions regarding year-end planning before the discussion about the cash-basis-to-accrual conversion. To confirm and document those communications, the engagement partner should have summarized each in an email to the client, including next steps and additional information required to continue the analysis.

Applying the judgment required by SSTS No. 7, the CPA should have realized that the permanence and significance of the change, the complexity of the calculation, and the CFO's lack of experience with changes in accounting method warranted written documentation. The CPA should have reviewed these matters, as well as the pros and cons of making the change, with the CFO. Moreover, these discussions should have been followed by correspondence summarizing discussions, client decisions, and reasons for the decisions.

NOT JUST FOR TAX ADVICE

Providing advice is expected of all CPAs. While this column focuses on the requirements for tax practitioners, all practitioners can benefit from documenting their advice in accordance with Circular 230, the SSTSs, and the other recommendations provided.

While there are no hard-and-fast rules, more comprehensive documentation is preferred to help mitigate professional liability exposure.

Documentation not only assists in the defense of a professional liability claim, but it also helps CPAs with collecting fees and assisting clients in understanding the CPA's advice and recommendations.

SSTS No. 7, paragraph 7

In deciding on the form of advice provided to a taxpayer, a member should exercise professional judgment and should consider such factors as the following:

1. The importance of the transaction and amounts involved
2. The specific or general nature of the taxpayer's inquiry

3. The time available for development and submission of the advice
4. The technical complexity involved
5. The existence of authorities and precedents
6. The tax sophistication of the taxpayer
7. The need to seek other professional advice
8. The type of transaction and whether it is subject to heightened reporting or disclosure requirements
9. The potential penalty and consequences of the tax return position for which the advice is rendered
10. Whether any potential applicable penalties can be avoided through disclosure
11. Whether the member intends for the taxpayer to rely upon the advice to avoid potential penalties

Circular 230, Section 10.37, Requirements for Written Advice

(a)(2) The practitioner must—

1. Base the written advice on reasonable factual and legal assumptions (including assumptions as to future events);
2. Reasonably consider all relevant facts and circumstances that the practitioner knows or reasonably should know;
3. Use reasonable efforts to identify and ascertain the facts relevant to written advice on each Federal tax matter;
4. Not rely upon representations, statements, findings, or agreements (including projections, financial forecasts, or appraisals) of the taxpayer or any other person if reliance on them would be unreasonable;
5. Relate applicable law and authorities to the facts; and
6. Not, in evaluating a Federal tax matter, take into account the possibility that a tax return will not be audited or that a matter will not be raised on audit.

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