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AICPA® Professional Liability SPOTLIGHT

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Risk Management: worth its SALT

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The AICPA Professional Liability Insurance Program has experienced more claims asserted against CPAs for providing tax services than all other accountants claims combined. While the volume of claims is greater for tax services, the severity, or the dollar amount paid on defense and indemnity, is typically low and usually not fatal to the survival of a CPA firm. However, tax claims related to state and local taxes (SALT) can be an exception. Some reasons for the increased severity of SALT claims include:

- A client may experience double-taxation if a new state determines that the client must file income tax returns for prior years, but the statute of limitation has expired in other states in which the client has filed. Thus, the client is unable to file amended returns to recoup taxes paid to other states.
- Liability for uncollected sales tax, which may no longer be collected from the customer.
- The inability of the client to obtain sales tax exemption certificates from its customers.

In all three circumstances, the client may seek to recover the additional tax it was required to pay from the CPA.

Without question, the labyrinth that CPAs face in dealing with SALT issues increases a firm's professional liability risk. What can a CPA do to help manage these risks?

CAN I GET A SECOND OPINION?

Claims sometimes arise when a client is not aware of additional state and local filing obligations or the CPA is unaware of changes in the law, such as when a state adopts an economic nexus standard. Consider the following example:

> A Virginia CPA was engaged to prepare a tax return for an Illinois-based executive coaching client. The client's employees met face to face occasionally with their clients throughout the country, but most coaching was performed via an internet platform. The CPA identified the possibility of nexus in states besides Illinois due to business travel associated with these engagements. However, the CPA concluded that the cost of preparing additional state tax returns would probably exceed the potential tax liability in each state. The CPA did not discuss this with the client and only filed the Illinois state tax return.
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> Several years later, the client complained about the amount of tax owed to Illinois and asked the CPA if it could be minimized. The CPA consulted with a SALT specialist, who identified that Illinois had changed its revenue apportionment methodology. Because the coaching services were delivered remotely, there was, in fact, an opportunity to reduce Illinois income and file other state returns showing little or no income and related tax, thus reducing the client's overall state tax liability.
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> When the client realized this methodology could have been employed for previous years, it made a claim against the CPA for the amount of Illinois tax it overpaid in years for which the statute of limitation had expired, precluding the filing of amended returns.

What could the CPA have done to reduce the likelihood of such a claim?

- **Inform clients of their options.** The CPA should have discussed the potential nexus issues with the client and requested the client's written instruction regarding filing in other states.
- **Stay up to date with changes in tax law.** Review changes in state tax laws annually. Instructions to state forms often provide a list of significant changes in tax law. In addition, AICPA Tax Section members have access to the Unique Considerations guides for the preparation of both business and individual tax returns. The guides highlight annual changes in tax law and unique tax treatments for each state.
- **Get a second opinion from a specialist.** If nexus issues are suspected and you do not have the expertise to evaluate them, consult practitioners with SALT expertise. However, realize that you, as the tax return preparer, bear ultimate responsibility for the tax return.

WHAT'S MY DIAGNOSIS?

Sometimes claims arise based upon a misunderstanding about the scope of services. Consider another example:

> A CPA firm had a client that operated fitness clubs across the country. When expanding to a new state, the client would ask the CPA firm to research the income and sales tax consequences of the expansion. The CPA firm performed the research and added the new state to a previously drafted memo, which included the research performed for all previously requested state evaluations.
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> One year, in the middle of busy season, the client requested an analysis for Texas. The CPA firm's SALT specialist, who was new to the engagement, misunderstood the scope of services to be provided and only researched the franchise tax treatment and failed to research the sales tax implications of doing business in Texas. Due to staffing demands and the confidence placed in the SALT specialist's work, the memo was not reviewed prior to delivery to the client.

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After it was audited, the client discovered membership fees were subject to sales tax in Texas. The taxes were no longer recoverable from its members. The client contended that the CPA firm should be held responsible for the uncollected sales tax.

What could the CPA firm have done to mitigate its risk?

- **Define the scope of services in the engagement letter.** If the CPA firm had clearly defined the scope of services to include solely the income tax consequences, the client could have corrected the engagement letter to include sales tax consequences. If the client did not ask for the correction, the CPA firm may have had a defense for this claim. In addition, the CPA firm should have ensured all team members were aware of the scope of services.
- **Review all deliverables prior to transmission to the client.** If review by a second firm member was not possible due to staffing demands, the individual who prepared the memo should have set it aside for a period of time, allowing for a secondary review upon further reflection.
- **Issue a separate tax memorandum for each research project.** If a previously issued memo is updated, the client may infer that all information in the memo has been updated. This approach may result in assertions related to the provision of incorrect advice if the tax laws in other states have changed and the memo was not updated to reflect these changes.

HOW CAN I MAKE A DIAGNOSIS WHEN I DON'T KNOW YOUR SYMPTOMS?

Claims may arise if the CPA does not fully understand the client's activity in other states. Consider a final example:

A client sold medical supplies to physician practices throughout the country. Sales representatives visited customers in all 50 states, and the CPA assumed all of their activities were considered solicitation of orders protected by the Interstate Income Act of 1959, P.L. 86-272. P.L. 86-272 prevents states from subjecting a business to net income taxes provided that the business's activities are limited to the "mere solicitation of orders" for the sale of tangible personal property and the orders are approved and filled from outside the state. The engagement letter stated that "federal and state" tax returns would be prepared.

A Minnesota auditor reviewing the client's website noted the duties of the client's sales representatives included storing and delivering replacement supplies and obtaining deposits from new customers. Based upon this discovery, the Minnesota Department of Revenue mailed the client a nexus questionnaire. The client instructed the CPA to complete the nexus questionnaire and return it to the state. However, the client did not review the questionnaire prior to the CPA's submission to Minnesota.

After receipt of the nexus questionnaire, the state initiated an income and sales tax audit. When the CPA told the auditor that the client did not have nexus, the auditor explained her findings and alleged that the nexus questionnaire was improperly completed because it failed to contain the information she had discovered.

In addition, the auditor requested sales tax exemption certificates, which the client had not obtained from its customers. As a result, a large amount of tax was due for both income and sales tax. The client instituted a claim against the CPA for the additional payments and asserted that no additional fees could be charged since the Minnesota returns were included in the scope of "state" returns.

How could the CPA firm have reduced its risk?

- **Understand the client's business.** Annually discuss client activities in other states with a senior client representative to ensure a complete understanding of the client's business. In addition, review company websites and social media. Often, these materials are written by marketing departments and may overstate the client's services, potentially creating unintended nexus issues.
- **Ensure the client reviews documents prior to submission.** Tax documents are a client's representations rather than the CPA's. In the scenario above, the auditor threatened additional penalties due to incorrect information being submitted on the nexus questionnaire.
- **Identify state and local tax returns for which the CPA is responsible in the engagement letter.** Engagement letters should specifically identify those state tax returns that will be filed, including form numbers.

FINAL THOUGHTS

Examples of severe SALT claims are included in this column, but there are also many small claims for simple errors on returns. The good news is that using an engagement letter that strictly defines the scope of services, understanding changes in the tax law, reading form instructions, and thoroughly reviewing deliverables may help mitigate the risk of a SALT claim.

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