Avoid These Tax Prep Ambushes

Backed by a 20-year resume in claims experience, Redwood City, Calif.-based Camico Mutual Insurance Co. has identified the areas and sources of frequent tax claims lodged against CPAs.

With tax season and tax planning always in full swing, here are some of the fruits of the company's experience with practitioner claims – and things to watch for as you wade through all those 1040s.

No. 1: ESTATE TAX RETURNS

Filing penalties. The estate tax return's irregular filing due date based on the decedent's date of death is the primary reason for missed estate tax return filings. Due to the high tax amounts reported on estate tax returns, the late filing penalties often exceed $100,000.

CPAs caught by such claims usually did not have any sort of estate tax return due-date calendaring system, or did not pay enough attention to any system they had implemented.

Camico recommends the following:

- Have only one person in the office be responsible for tracking estate tax return filing deadlines (rather than each tax partner or tax manager tracking their own deadline);
- Have a due-date tracking system for estate tax returns. The system can extremely simple, such as a large paper calendar devoted solely to estate tax return due dates. A calendar is effective as long as it is posted in a conspicuous, frequently viewed area.
- Continually review the estate tax return tracking system to ensure that your firm meets any impending due dates that the system identifies.

Payment penalties. CPAs may also incur late-payment penalties by not realizing that:

- An estate tax payment extension request requires a separate section of federal Form 4768 be completed to receive a payment extension;
- The payment extension is not automatic (like the filing extension), and requires evidence demonstrating “reasonable cause;” and,
- Due to the discretion that the Internal Revenue Service can exercise with respect to granting the payment extension (because of the “reasonable cause” requirements) the payment extension should be done will in advance of the estate tax due date, in case the IRS denies the estate tax payment extension request.

No. 2. ENTITY SELCTION ISSUES

Claims in this area arise because the CPA (not the client) chose the “best” entity for the client’s new business, and because the CPA did not document the advice that was provided to the client.

The client must select the entity that they feel is the best fit for the new business – not the CPA. Each entity type has positive attributes and negative attributes could surface if certain unforeseen future events occur. The client will then be able to successfully assert that a different entity type would have netter addressed the unforeseen future event that occurred.

Provide the client with a complete list of available entity alternatives, and each entity type’s attributes and detriments. The client should then choose the entity that they feel best complements their business. This helps insulate the CPA from liability if the client’s choice does not prove to be “best,” as long as the CPA can document the information provided to the client. Accordingly, be sure to document the information provided.

No. 3: FORMS 5471 AND 5472

A $10,000 penalty applies when either a Form 5471 or a Form 5472 was due but was not filed. The penalty most often is triggered because the CPA was not aware of the form's filing requirements.

Both Forms 5471 and 5472 have extremely complex filing requirements that are beyond the scope of this article. However, your firm can use the following easy-to-memorize rules to help identify situations where a federal Form 5471 or 5472 might be required:

- Is an individual client an officer or director of a foreign corporation, or is any client a shareholder in a foreign corporation where the share ownership equals 10 percent or more of a foreign corporation's stock? If so, your firm should consult the Form 5471 instructions to determine whether your client must file the form.

- Is any corporation client a foreign corporation, or owned 25 percent or more (directly or indirectly, by vote or value) by a foreign individual or entity? If so, your firm should consult the Form 5472 instructions to determine whether your client must file the form.

Note: Several filing exceptions exist if the client did not have reportable transactions (see the "reportable transactions" definition in the Form 5472 instructions).

The best way to be aware that your client is a foreign corporation stock or is a foreign corporation's officer or director (Form 5471) is to ensure that your firm requests the applicable information from the client.

No. 4: EXTENSION PAYMENTS

Another recurring claim involves income tax filing extension payment calculations. Typical scenarios involve the CPA obtaining missing tax data over the phone from the client. The CPA then calculates the due tax payment, and the client mails the tax extension and payment prior to April 15.

Later in the year, though, when the CPA has the client's actual tax data that was missing on April 15, the client's previously provided oral estimates prove to be wildly off the mark: The actual amounts are much higher, and the client will owe a much greater tax amount (with accompanying late-payment penalties). Once the client sees the late-payment penalty amount, the client "forgets" the phone conversation on April 15 and now demands that the CPA pay the due penalty.

A written confirmation of the amounts used to calculate the extension payment should be sent to the client with the extension form. This gives the client an opportunity to review the information and to change any information that appears incorrect, prior to April 15. The confirmation also serves as a record of the client's representation in case the client incurs a late-payment penalty and forgets the representations that were made in April.