Tax Quality Control – A Risk Control Perspective

For almost two decades, malpractice claims arising from tax practice at public accounting firms have accounted for about two-thirds of all AICPA Professional Liability Insurance Program claims.1 Many of these claims could have been prevented if the firms had adopted tax quality control policies and procedures, promoted them, and monitored their compliance. The following are examples of common claim scenarios:

Scenario 1:

- A C Corporation did not provide its CPA with the information necessary to prepare its corporation income tax return until Sept. 14, 2004.
- The CPA rushed to complete the client’s Form 1120 and forgot to file Form 3115, Application for Change in Accounting Method, with the 2003 tax return.
- The taxpayer changed its method of accounting for depreciation based on the CPA’s recommendation.
- The CPA did not complete the Form 1120 checklist, which is a quality control procedure required by the firm. The firm did not catch the omission when the return was reviewed prior to filing.
- The IRS audited the corporation’s returns in 2009 and discovered that Form 3115 was not filed. The auditor disallowed the change in accounting method. As a result, the company owed additional taxes, penalties and interest.

Scenario 2:

- A CPA attended a workshop on tax strategies for partnerships and recommended the strategies to several clients.
- The CPA arranged for a client to receive cash under a loan with an inflated interest rate.
- The client contributed the cash to the partnership, which assumed the loan and incurred a tax loss when he later sold the partnership interest.
- During an IRS audit, the tax loss was disallowed because it lacked economic substance.
- The CPA did not research IRS listed transactions and failed to recognize the recommended transaction as a tax shelter, commonly known as “Son of Boss.”
- The taxpayer was assessed substantial penalties due to failure to disclose participation in the transactions.

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1 Based on tax claims received from the AICPA Professional Liability Program
Tax claims resulting from inadequate quality control continue to proliferate, in part, because some practitioners view incorporating a system of quality control in their tax practices as a voluntary rather than necessary measure. This guide will discuss, from a risk control perspective, the significance of tax quality control; provide an overview of its correlation to claims by each quality control element; and offer a risk control checklist that can assist firms in enhancing their quality control systems.

**Tax Quality Control as Risk Control**

An effective tax quality control system that is well designed and regularly monitored can help CPA firms mitigate the risk of experiencing malpractice claims, avoid preparer penalties and disciplinary action, and avert breakdowns in the tax compliance process. Compliance with established quality control policies and procedures can enable the firm to provide quality services to its clients while improving the operating effectiveness of its tax practice. For example, it can improve the timeliness of responses to client inquiries and help identify tax-savings opportunities or potential tax problems.

Every firm should have a tax practice quality control manual with prescribed policies and procedures, as well as checklists for various tax services. The AICPA and accounting industry publishers offer various resources to assist sole practitioners and firms in maintaining a tax quality control system.

The Statements on Quality Control Standards (SQCS) for accounting and auditing practices lists six elements of a quality control system:

- Leadership responsibilities for quality within the firm (tone at the top);
- Relevant ethical requirements;
- Acceptance and continuance of client relationships and specific engagements;
- Human resources;
- Engagement performance; and
- Monitoring.

These elements, detailed in the ensuing sections, can be easily adopted into any firm’s tax practice.

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2 In December 2005, the AICPA Tax Division proposed Statement on Standards for Tax Services No. 9, Quality Control, to promote the importance of quality control for tax practices. In early 2007, the AICPA Tax Executive Committee concluded not to issue the standard after reviewing comments received on the exposed draft.

3 [AICPA Tax Practice Quality Control Guide](#)
Leadership Responsibilities for Quality within the Firm (Tone at the Top)

A firm’s leadership determines the internal culture of the firm. Firm leaders set examples for all levels within the firm through their conduct, reinforced by consistent and frequent actions and messages. From a risk control perspective, leaders who do not promote the importance of quality in performing services for clients increase their firms’ exposure to malpractice claims. An “open door” policy should be promoted, reinforcing the responsibility of employees to communicate with firm management regarding violations of the firm’s quality control policies and procedures without fear of reprisals.

In practice, some firm owners may retain a client lacking integrity to avoid loss of revenue, or staff tax return preparers may try to meet their performance goals by skipping procedures in order to stay within the job-budget hours. Firm leadership must reinforce the importance of quality control over monetary considerations. Ultimately, replacing unethical or problem clients and pricing work adequately to support quality control will contribute to both improved financial results and reduced risk of experiencing malpractice claims.

Furthermore, quality control compliance should be incorporated into performance goals, and adequate resources should be allocated to support it.

Relevant Ethical Requirements

Firms should establish policies and procedures to ensure that all personnel perform their responsibilities with integrity and objectivity in accordance with the AICPA Code of Professional Conduct. Additionally, firms should refer to the AICPA Statement of Standards for Tax Services (SSTS), Treasury Department Circular No.230 (Circular 230), and guidance from the Internal Revenue Service (IRS) and other regulatory agencies when performing tax compliance or consulting services. CPAs should advocate a client’s tax position only if they believe, in good faith, that the position would satisfy professional standards, the law, and requirements by applicable taxing authority. Justifications for appropriate departures should be adequately supported by competent authority and documented as such. CPAs should never subordinate the firm’s judgment to that of a client or succumb to a client’s pressure to advocate an unsupportable tax position. They should consider withdrawing from preparing the tax return and terminating their professional relationship with the taxpayer if the client insists on taking a unsupportable tax position in the return.

4 QC §10.15-.18
5 QC §10.17-.26
Practitioners often do not recognize conflicts of interest until allegations are brought against them at a later date. For example, CPAs sometimes represent clients who develop adverse interests during the engagement, such as divorcing clients or partners in dispute.

If they continue to represent both parties, they could later face disciplinary complaints or malpractice claims from a client who believes they were treated unfairly in the divorce settlement or division of partnership assets. Some believe that obtaining signed waivers of conflicts of interest from all parties involved can prevent claims alleging a conflict of interest. However, the protections afforded by such waivers under applicable law vary substantially by jurisdiction, and should be drafted only with the assistance of competent legal counsel.

In addition, firms must take care to protect client confidentiality when a potential or actual conflict of interest exists. For example, while in the course of preparing for a divorce, the spouse of a business owner may request information that is confidential to the business. Clients may request confidential information about another client. A client also may provide information pertaining to another client that the practitioner knows will have a detrimental effect on that client, which may be untrue and may raise concerns regarding client integrity. In each of these instances, the practitioner has a duty to maintain confidentiality over such information based on professional ethics standards under AICPA Code of Professional Conduct, Rule 301, along with IRC §7216 and its regulations.

Prior to acceptance of new clients, and at least annually for continuing clients, firms should consider their existing relationships with other clients. To the extent such relationships present an actual conflict of interest or could be viewed by the client as a potential conflict of interest, this should be disclosed and discussed with the client prior to acceptance and continuance. CPAs are required to comply with Rule 102 of the AICPA Code of Professional Conduct, Integrity and Objectivity, which in part addresses conflicts of interest.

Additionally, firms should conduct inquiries of employees at least annually regarding conflicts of interest, or more often, as warranted. The procedure will help identify potential or actual conflicts of interest related to employee activities. Any conflicts of interest discovered must be reported to engagement partners and disclosed to clients.

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7 ET §391.031-.032 and ET §591.377-.378
Acceptance and Continuance of Clients and Engagements

From a risk control perspective, “problem clients” are more likely to generate malpractice claims. Examples include clients who lack integrity; who have outstanding tax delinquencies for multiple years, inadequate supporting records or continuing unpaid fees; or who are chronically late in providing information. An effective policy on acceptance and continuance of clients and engagements can help screen out such clients. Firms should review their existing client base at least annually. The end of tax season is a good time to do so, while memories of problems remain fresh. The firm should also conduct a pretax season review of existing clients to identify clients whose professional relationships with the firm should be discontinued before the firm sends out annual engagement letters.

Firms should perform some due diligence before accepting new tax clients. Accepting new engagements wherein client accounting records are inadequate or disorganized can be problematic. For example, a small business client may submit credit card statements which include both personal and business expenses, and expect the accountant to decipher the information and classify expenses before preparing the tax returns. The client may later dispute the fees for the additional time incurred to assemble the necessary information, or the filing deadline may be missed because required information is not available. In addition, if the client is audited and a tax assessment is made based on incorrect classification or inadequate support documentation for the business expenses, this may become the basis for a negligence claim against the CPA. Some clients may not accept personal responsibility if inadequate accounting records or other supporting tax return information results in an additional tax assessment. Firms should consider the integrity and cooperativeness of prospective clients and their history with other professional service providers in client acceptance and continuance.

The quality control policy should specify conditions that would cause the firm to reject a client or engagement, and require approval of the managing partner or a member of the firm’s executive committee to grant an exception to the policy.

When ending a professional relationship with a client, firms should issue a termination letter. Oral terminations can lead to disputes about continuing responsibilities to the client on matters such as extensions of time to file, informing clients about outstanding filing deadlines, or out-of-state filing obligations. Such disputes can lead to claims arising from the former client’s untimely filing or failure to file the returns. Termination letters should be factual and discuss the items that need the client’s attention.

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8 QC §10.27-.36
Finally, CPAs should consider the inherent risks of accepting too many engagements. Inadequate planning regarding workloads and required resources during tax season invariably results in long working hours and increased errors.

**Human Resources**

In evaluating claims arising from tax practice, practitioners tend to focus on the nature of errors or omissions made in rendering tax advice or preparing returns. However, the underlying cause of many tax claims is not the error or omission itself, but rather inadequacies in three areas: staffing, training and supervision.

**Staffing**

Advance resource and workload planning and proper assignments can help prevent bottlenecks and mistakes. The chance of errors or omissions increases when supervisors or managers become overloaded, or when new or less-experienced personnel are assigned to prepare specialized or complicated returns. A high staff-to-reviewer ratio is one indicator of inadequate resources.

**Training**

Training is an important part of professional development and is required to comply with continuing professional education requirements. An effective system of quality control necessitates that all personnel understand firm policies and procedures in the context of professional and ethical standards. Annual training on firm quality control policies and procedures should be combined with a formal ethics and technical training program. All professionals should maintain current knowledge of applicable professional standards, laws and guidance, such as the AICPA Statement of Standards for Tax Services (SSTS), Treasury Department Circular No. 230 (Circular 230), federal and state tax law, authoritative guidance, and new collection initiatives (e.g., tax-amnesty programs).

CPA firms increasingly depend on sophisticated tax software to manage both return preparation and quality control. Accordingly, the importance of training should not be overlooked, especially given recent enactments of multiple tax acts containing numerous provisions and varying implementation and expiration dates. CPAs should not simply assume that their tax software is up-to-date with the latest changes when tax acts are frequently enacted at year end.
Supervision

Continuous evaluation of the capabilities and competencies of professionals for assignment and development purposes is an important quality control procedure. In practice, practitioners learn primarily through “on the job” training, reinforced by formal training. Planning for adequate supervision and review of returns, especially those prepared by new or inexperienced staff, is crucial to maintaining an effective tax quality control system.

Engagement Performance

The AICPA Code of Professional Conduct, ET §57.03, states that members should “Practice in firms that have in place internal quality control procedures to ensure that services are competently delivered and adequately supervised.”10 Firms should establish policies and procedures designed to ensure that firm personnel adhere consistently to ethical and professional standards as well as regulatory and legal requirements when rendering professional services.11 Any departure from firm policy and procedures should be formally approved by a responsible firm partner and documented.

A sole practitioner or a partner who has primary responsibility for a firm’s tax practice should be aware of their responsibility under Circular 230 §10.36, Procedures to ensure compliance.12 The standard prescribes that tax advisors have a responsibility to oversee their firm’s practice of providing advice concerning federal tax issues and preparing or assisting in the preparation of submissions to the Internal Revenue Service.13

Additionally, firm leaders should take reasonable steps to ensure that the firm’s policies and procedures are consistent with the standards of practice set forth in Circular 230, §10.33, Best practices for tax advisors, to provide clients with high quality services. They include:

- Communicating clearly with clients regarding the terms of the engagement, including the form and scope of the advice or assistance to be rendered;
- Discussing any concerns about a tax return position with the client. This includes reviewing the relevant facts and authorities supporting the position; possible challenges to the position by taxing authorities; and the additional taxes, penalties and interest that could apply in the event the position is disallowed. The client should be informed about the possible professional and legal costs associated with

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10 SQCS, QC §10.57 – .84, and AICPA Tax Practice Quality Control Guide
11 QC §10.57
13 This standard has similar requirements to QC §10.15, Leadership Responsibilities for Quality within the Firm.
defending the tax position, if required. Discussions should be documented in a written communication to the client;¹⁴

- Establishing the facts by applying due diligence in gathering and assembling tax information, and making inquiries if the information provided appears to be incorrect, incomplete or inconsistent; determining which facts are relevant; evaluating the reasonableness of any assumptions or representations; analyzing the applicable law and case law to the relevant facts; and arriving at a conclusion adequately supported by the law and the facts;
- Advising clients regarding the risks and consequences of the conclusions reached (e.g., a challenge by tax authority may result in additional tax, penalties and interest);
- Acting fairly and with integrity in practice; and
- Implementing procedures to ensure adherence to practice standards within the firm.

In its guidance on professional responsibility and the Report of Foreign Bank and Financial Accounts (FBAR), the Office of Professional Responsibility stated that “good faith reliance contemplates that a practitioner will make reasonable inquiries when a client provides information that implies possible participation in overseas transactions/accounts subject to FBAR requirements.”¹⁵

From a risk control perspective, firms should establish an understanding with clients about services to be performed in the form of annual engagement letters. Each letter should define carefully the scope of engagement to prevent later scope disputes. The firm’s role, responsibilities and related limitations should be clearly communicated in the letter, as well as the client’s responsibilities under the engagement.¹⁶

In addition, firms should document all oral advice in an e-mail or memorandum to the client, as applicable. The document should summarize the firm’s discussion with the client, including the client’s question(s); the facts provided by the client; the advice given by the firm, with supporting authorities; and action items to be completed by the client and/or the firm in support of the advice provided. To the extent additional information is needed from the client, the document should indicate that the advice provided is incomplete and subject to change based upon the firm’s review of such information. It also should indicate that any advice provided is based solely on the limited information provided by the client. Lastly, the document should include precautionary language to

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the effect that advice is based on facts as stated and authorities that are subject to change.\textsuperscript{17}

Many tax claims result from incorrect, incomplete or off-the-cuff advice given to clients. Incomplete or missing documentation of client communications jeopardizes the defense of such claims. A lack of adequate documentation is a key factor in the settlement of claims that would otherwise be defensible.

**Monitoring**

The ongoing monitoring of compliance with policies and procedures is central to a firm’s quality control system. Failure to regularly monitor compliance increases the risk of experiencing malpractice claims. Firms should conduct an annual quality control compliance self assessment, and engage an independent external reviewer every two or three years to inspect and review its compliance with policies and procedures.

Quality control inspections are an integral part of the monitoring process.\textsuperscript{18} If conducted with objectivity, self assessment can be valuable to a firm in determining if firm professionals comply with applicable quality control policies and procedures. During self assessment, differences among offices and variations from written policies and procedures should be identified, explained and documented. It is impractical to test every engagement for compliance with all professional standards and components of the firm’s system of quality control. AICPA peer review standards indicate that engagements selected for review should represent a reasonable cross section of a firm’s engagements, focusing on significant risk areas and high-risk engagements (e.g., advice or compliance services related to tax shelters).\textsuperscript{19} The quality of selected tax work should be tested to determine if it met clients’ needs and was substantively correct, documented adequately, and communicated timely to the client.

Findings of significant deficiencies and noncompliance should be summarized and reported with recommendations to management so that disciplinary, remedial or corrective actions can be taken immediately. A report on the results should be provided to firm personnel. Some firms conduct a post-tax season meeting to discuss issues encountered during tax season and encourage employees’ involvement in improving the firm’s quality control systems.

\textsuperscript{17} Refer to TS Section 700, *Form and Content of Advice to Taxpayers*

\textsuperscript{18} Refer to the article, "Why and How to Conduct a Tax Practice Inspection" by Mark A. Sellner, *The Tax Advisor*, June 2009.

\textsuperscript{19} AICPA Professional Standards, PRP Section 100, *Standards for Performing and Reporting on Peer Reviews* (and related Interpretations and Guidance)
If outside reviewers are engaged to conduct quality control inspections, a written non-disclosure agreement should be prepared and signed, requiring reviewers to maintain confidentiality and comply with applicable professional standards, laws, regulations and contractual requirements. For example, a reviewer or its personnel should not retain documents with information that may identify taxpayers by name or number.\textsuperscript{20} Regular and objective monitoring of compliance is essential to a good quality control system and helps prevent malpractice claims.

**Conclusion**

Implementing and maintaining an effective tax quality control system which includes the six elements of a quality control system contained in the AICPA *Statements on Quality Control Standards* improves the quality of services to clients and reduces the risk of experiencing tax malpractice claims. Regardless of whether a firm is a sole proprietorship or a larger firm with multiple offices, over time, this leads to improved client satisfaction and financial results.

\textsuperscript{20} Refer to Treas. Reg. §301.7216-2T (p), Disclosure or use of information for quality or peer reviews.
Tax Risk Control Checklist

The following sample checklist should be modified by each firm based upon the scope and complexity of its tax practice, and is not intended to be comprehensive. It is based on overall tax claim experience in the AICPA Professional Liability Insurance Program and can be incorporated into a firm’s existing quality control procedures.

<table>
<thead>
<tr>
<th>TAX RISK CONTROL CHECKLIST</th>
<th>RESPONSE (Each Yes response indicates good risk control)</th>
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<tbody>
<tr>
<td><strong>Leadership Responsibilities for Quality</strong></td>
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<tr>
<td>1. Firm management prohibits exceptions to or departures from firm quality control policies and procedures without reasonable justification and approval by an executive committee or managing partner.</td>
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<tr>
<td>2. Within a multiple-office firm, home office management responsible for quality control exercises oversight of each office.</td>
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<tr>
<td>3. The managing partner adequately supervises other firm partners to ensure compliance with the firm’s quality control systems.</td>
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<td>4. The firm promotes quality over efficiency in rendering services and compensates employees accordingly.</td>
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<tr>
<td>5. The firm’s quality control partner has adequate authority to monitor and enforce compliance with quality control.</td>
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<tr>
<td><strong>Relevant Ethical Requirements</strong></td>
<td></td>
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<tr>
<td>1. The firm assesses new and continuing engagements and employee relationships for potential and actual conflicts of interest, and discloses them to the client as required under professional standards.</td>
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<tr>
<td>2. The firm engages an attorney for assistance in drafting waivers of conflicts of interest. 21</td>
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<td>3. The firm obtains written client consent as required under law and professional standards prior to responding to requests for</td>
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21 See AICPA Rule 102, Cir. 230 §10.29, state board of accountancy rules and regulations, etc.
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<th>Acceptance and Continuance of Client Relationships and Specific Engagements</th>
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<tbody>
<tr>
<td>1. The firm declines clients with substantial outstanding fees and those who are perpetually late with information or lack integrity.</td>
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<tr>
<td>2. The firm issues termination letters when concluding a professional relationship with a client.</td>
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<tr>
<td>3. Before accepting a new engagement, the firm reviews the condition of the client’s accounting records and considers required resources and timing to complete the work.</td>
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<tr>
<td>4. Prior to accepting a tax compliance engagement, prospective clients with poorly maintained accounting records are advised to retain the firm or a qualified third party to correct their records.</td>
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<tr>
<td>5. The firm declines tax engagements it is not qualified to perform.</td>
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<tr>
<td>6. The firm requires annual engagement letters for all tax clients.</td>
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<tr>
<td>7. The firm engages an attorney for assistance in drafting engagement letters.</td>
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<tr>
<td>8. The firm performs risk assessment and establishes controls to mitigate risks before accepting high-risk clients or engagements.</td>
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<tr>
<td>Human Resources</td>
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<tr>
<td>1. The firm assigns engagements based on knowledge and experience rather than</td>
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22 IRC §7216 and its regulations, ET §391.031-.032, and ET §591.377-.378
2. The firm maintains adequate staffing and regularly reviews tax work flow to identify bottlenecks.

3. The firm provides continuing employee training on tax law, regulation, professional standards, and the use of technology, enabling employees to be technically and technologically savvy.

4. The firm closely supervises employees who are in training or performing services wherein they lack experience.

### Engagement Performance

1. The firm conducts adequate research prior to accepting advice or opinions from peer firms or third parties.

2. The firm discloses or uses client information in accordance with tax law, tax authorities’ guidance and professional standards.

3. The firm uses encryption software to protect confidential client information from unintended or unauthorized access and includes confidentiality notices and disclaimers in all electronic communication.

4. The firm restricts access to tax software to authorized personnel servicing firm clients.

5. The firm restricts employee access to client tax files except as needed to render services.

6. The firm has established electronic protocols, formats and standards for saving and maintaining client data and working papers, and monitors for compliance.

7. The firm provides a letter with caveats and disclaimers to clients when referring them to external specialists.

8. The firm uses checklists to prevent errors or omissions and monitors compliance for effective use.

9. All paper tax return drafts provided to clients contain a DRAFT stamp or watermark, and
are accompanied by a cover letter restricting their use or distribution.

10. All electronic tax return drafts should be encrypted and password-protected in e-mails with language restricting their use or distribution.

11. The firm requires client review and written approval of draft tax returns prior to filing.

12. The firm issues a transmittal letter with all paper tax returns, providing clients who elect out of the e-filing mandate with filing instructions and due dates.

13. The firm requires signed copies of electronic filing authorization forms prior to filing client returns electronically.

14. The firm maintains confirmation of acceptance receipts from tax authorities for returns filed electronically, and certified mail receipts if returns are sent by U.S. mail.

15. When taking a tax position, the firm documents its support or justifications for appropriate departures from authoritative guidance.

16. The firm documents oral advice in correspondences to clients and follows up with them as applicable.

17. Engagement partners review all tax advice on significant issues before it is provided to clients.

18. Tax advice is communicated to clients in writing. All communication complies with requirements prescribed by professional standards (e.g., SST, Circular 230, §10.35) and includes any applicable restrictions, caveats and disclaimers.

<table>
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<tr>
<th>Monitoring</th>
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<tr>
<td>1. The firm conducts annual self assessments and engages an outside reviewer to monitor compliance with quality control policies and procedures every two to three years.</td>
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</table>
2. The firm maintains objectivity while performing self-assessment.

3. Following tax season, the firm solicits input from employees to identify issues and solutions to improve quality and effectiveness.

Resources and References:

- AICPA Tax Practice Guides and Checklists
- AICPA Guidelines for Voluntary Tax Practice Review
- AICPA Statements on Standards for Tax Services
- AICPA Statements on Quality Control Standards
- AICPA Standards for Performing and Reporting on Peer Reviews
- Treasury Department Circular 230
- "Why and How to Conduct a Tax Practice Inspection" by Mark A. Sellner, *The Tax Adviser*, June 2009

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