

Avoiding Litigation in a Tax Practice

by
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Claims arising out of tax practices have become the most frequent type of malpractice claim. Tax practice litigation claims are often straightforward, but they are very time consuming and can have devastating consequences for practitioners.

Too, while malpractice insurance costs have dropped to historic lows, close to one-half of all practitioners still do not carry insurance. Paying insurance deductibles can be a financial burden, and if a claim is filed, it also comes with these hidden costs:

- **Time Loss.** Accountants spend enormous amounts of time reviewing files, educating insurance personnel and defense counsel, experts and the other side's attorney about technical matters and underlying facts.
- **Emotional.** Acute embarrassment and emotional loss are often a factor — sometimes undermining financial performance while litigation is pending.
- **Professional Reputation.** Although uncommon, adverse publicity or rumors about a high profile lawsuit or settlement can tarnish a career-long reputation for excellence.

Key To Loss Prevention

The key to understanding and applying loss prevention techniques is to recognize that the search for fault is the cornerstone of our tort liability system. This means that a malpractice claimant must establish that the accountant was at fault for the alleged damage. If the defendant can show that the plaintiff was to blame, either in whole or in part, then recovery can be barred or proportionately diminished.

What can you do to take advantage of our "fault based" tort system before you face a claim? Very nearly all preventative measures recommended by loss prevention consultants are premised on the notion that responsibility for conduct and decision making can and should be transferred to your client in a fashion that clearly demonstrates that the client agreed to bear the risk of a bad outcome.

Tax Advice Claims

It is hardly surprising that the complexity of tax law combines with the frailty of human communications to make tax advisory services a significant source of claims. Some examples are tax shelters, S-corp election or revocation, alternative minimum tax issues, purchase price allocation, recapture tax, inaccurate tax projections, and mergers, acquisitions and liquidations.

These are the generic types of tax advisory services claims:

1. **Lack of Direction (Poor Communications).** The lack of a clear understanding between the tax advisor and client concerning the nature and scope of services to be rendered and the tax advisor's responsibilities as compared to the responsibilities of other advisors (principally attorneys), is a fundamental — often fatal — shortcoming. Questions about whether it was the accountant's task to solicit all information needed to make an accurate projection or the client's duty to produce it are legion.

Other problems arise when there is a lack of coordination between the accountant and other professional advisors to the client about who is to perform what tasks, e.g. - whether the attorney or the accountant is required to make an S-corp election filing.

2. Haste Makes Waste. Requests for last minute tax advice on significant transactions often lead to mistakes, bad results and malpractice claims.

3. Conflicts of Interest. Giving tax advice to both sides of a transaction will almost always lead to trouble. Conflicts can also arise after the fact, when previously congenial tax clients sharing a common interest (common business ownership, spouses) have a falling out, one or both start pointing blame at their financial professional.

4. Bad Clients. A bad client is anyone who has the traits or features which make it more likely that they will act on a disappointing result by bringing a lawsuit or asserting a claim. Most often, bad clients are individuals who have unrealistic expectations, combined with personality traits that can be a potent impetus for taking action in court. These traits include being overly aggressive, angry at "the system", chronic complainers, clients who frequently change professionals, the dishonest and litigious.

To minimize claims on tax advisory services, consider the following:

1. Always have a written engagement letter when giving any tax advice of consequence, including a demarcation of responsibility between all involved professionals.
2. Last minute, "rush projects" should be rejected or documented to enumerate the circumstances surrounding the engagement and its limitations.
3. Conflicts of interest should be avoided or, at the very least, clients on both sides should be asked to execute a conflict waiver agreement. Consider withdrawing rather than simultaneously performing services for clients with competing interests.
4. Bad clients should be ferreted out, screened and rejected.

Finally, TX e182, from Statements on Responsibilities in Tax Practice,

contemplates that tax advice might best be communicated in writing. Factors to consider here include the significance of the transaction, the specific or general nature of the client's inquiry, the time available, technical complications, the tax sophistication of the client and whether the client should be advised to seek legal advice.

Tax Preparation and Procedural Errors

Most claims for untimely filings, computational errors or the improper application of tax law are conclusive and cannot be defended except on questions of damage amounts.

One claim now asserted more often is that a tax return preparer was too aggressive, resulting in additional taxes, penalties and interest. A client might recover penalties and interest if the accountant lacked a good faith belief that the return had a realistic possibility of being sustained. Clients are occasionally awarded the tax itself if they changed their financial position in reliance on the earlier filed return.

Taxpayers sometimes try to hold a tax return preparer liable for tax, asserting that the preparer had to ensure that supporting documentation was legally adequate. Most practitioners minimize this risk by having clients acknowledge their responsibility for documentation. Moreover, TX e132 of Statements on Responsibilities in Tax Practice provides that a CPA may, in good faith, rely on client information without verification. That is, unless the preparer has reason to disbelieve the information.

What if information generated in the preparation of one tax return discloses information or facts adverse to another client? Conflicts of interest between simultaneous tax return clients are

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increasing as a source of malpractice litigation. These consist of:

1. Conflicts over the use of information, such as when information from client A discredits client B's return, or suggests that A is taking advantage of B.

2. Differences over tax planning issues, where there is allocation discretion.

3. Disclosure of information on a common tax return to either side, when the taxpayers are at odds over some collateral dispute.

Warring spouses or dueling partners may ask their return preparer to take their side, or become angry when they perceive that the CPA is siding with their enemy. For example, a divorcing spouse might claim that her tax return preparer should disclose information learned from the husband which showed that he was secreting assets.

In situations of client conflicts the CPA should maintain strict neutrality and independence. In intractable situations, the accountant should consider withdrawal.

However, beware that withdrawal is a sensitive matter, often leading to bruised egos or hurt feelings. Thus, withdrawal should be handled cautiously. Withdrawal should only occur after completion of the engagement, or with enough notice to allow the client to retain a successor and still meet deadlines. An unpaid bill is a good reason to withdraw, but timing can be everything in such a circumstance.

Conclusion

Tax accountants can do much to minimize their exposure to malpractice claims, especially by:

1. Always communicating clearly with clients and often in writing.

2. Making it clear that it is the client's responsibility to decide.

In difficult cases, practitioners should consult with their liability carriers or legal counsel. ■



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