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Tax Malpractice: Areas in Which It Occurs and the Measure of Damages--An Update

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TAX MALPRACTICE: AREAS IN WHICH IT OCCURS AND THE MEASURE OF DAMAGES—AN UPDATE

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INTRODUCTION

About five years ago, I published an article exploring the areas in which reported tax malpractice cases arose.[1] As a secondary inquiry, that article, hereinafter referred to as *Malpractice I*, also focused on the measure of damages awarded in such cases. The result of that study indicated that many of those cases involved general malpractice in a tax context, as opposed to "tax malpractice." Many of the errors involved missing time deadlines, such as late-filing and non-filing of tax returns. Other errors included "ignoring or overlooking some simple, clearly mandated requirement such as making an election or obtaining consent" when necessary.[2] Apart from a large number of tax shelter-related cases, which arose from the tax shelter frenzy of the late 1970s and early 1980s, and cases in the estate planning/estate and gift tax area, *Malpractice I* was unable to identify or predict any area or areas of tax practice more likely than others to spawn tax malpractice litigation.[3] *Malpractice I* did allay my worst fear that due to the complexity of the tax law there would be innumerable instances of tax malpractice involving virtually every section of the Internal Revenue Code (I.R.C.).[4]

In the years since the publication of *Malpractice I*, I have received a number of calls and e-mails from practitioners inquiring as to whether, in the course of my research, I had encountered a situation "on all fours" with the one they were working on. One of these inquiries even led me to explore whether issuing an incorrect federal information return, such as a W-2 form or a form 1099, could be the basis of a tort recovery similar to recoveries for tax malpractice.[5] These inquiries convinced me of the continuing importance of this area. As if further encouragement were needed, the recent Internal Revenue Service (IRS) crackdown on attorneys and accountants involved in the sale of overly aggressive and likely flawed tax shelters[6] following in the footsteps of a number of financial scandals—such as Enron, which had accounting and tax machinations at its core[7]—

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[1] Jacob L. Todres, *Malpractice and the Tax Practitioner: An Analysis of the Areas in Which Malpractice Occurs*, 48 EMORY L.J. 547 (1999).

[2] *Id.* at 551.

[3] *Id.* at 641–42.

[4] *Id.* at 551.

[5] Jacob L. Todres, *Torts, Tax Reporting and Preemption: Is There Tort Liability For Incorrect Information Reports?*, 28 J. CORP. L. 259, 260 (2003).

[6] *See, e.g.*, Kenneth A. Gary, *Year In Review: Tax Shelter Crackdown Efforts Steer Government Policy*, 102 TAX NOTES 35, 35 (2004); Press Release, Internal Revenue Service, Tax Day Reminder: Treasury & IRS Continue Crackdown on Abusive Tax Shelters (Apr. 15, 2003), http://www.irs.gov/pub/irs-news/ir-03-51.pdf.

[7] *See generally* JOINT COMM. ON TAX'N, 108TH CONG., REPORT OF INVESTIGATION OF

emphasized the importance to society of a developed and principled body of law governing when and to what extent professional advisors might be held financially responsible for their advice.

Primarily, this Article will analyze the tax malpractice cases that have been reported since *Malpractice I* was published from the vantage of substantive tax law to attempt to ascertain whether certain areas of tax law or certain aspects of tax practice seem to generate more malpractice claims than others. As a secondary inquiry, the Article will discuss the proper measure of damages recoverable on account of such malpractice.

This Article focuses solely on reported cases. It examines instances of claimed malpractice involving federal income, estate, gift, and generation skipping taxes. It does not focus on other federal taxes such as employment taxes. While state and local taxes are not intended to be focused upon separately, this Article discusses several cases that involve allegations of wrong advice in connection with state sales tax[8] and state personal property tax.[9] While I have attempted to locate and review all of the reported cases, I acknowledge the possibility, or more accurately, the likelihood, that I missed some,[10] especially since tax malpractice situations continue to sometimes lurk in esoteric venues. For instance, I will discuss an interpleader action where the court allocated the proceeds from a tax malpractice settlement,[11] and an action to set aside a divorce settlement that refers to a previous tax malpractice litigation arising from the same divorce.[12]

Both tax attorneys and accountants are focused on in this study. While, from a purely theoretical standpoint, it might be desirable to

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ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES AND POLICY RECOMMENDATIONS (2003) (discussing the unscrupulous accounting practices in Enron and making recommendations for future legislation), *available at* http://www.house.gov/jct/5-3-03-vol1.pdf; Neal Batson, Court Appointed Examiner, Second Interim Report, *In re* Enron Corp., No. 01-16034 (AJG), at *3 (Bankr. S.D.N.Y. Jan. 23 2003), http://www.enron.com/corp/por/pdfs/examiner2/InterimReport2ofExaminer.pdf.

[8] *See infra* Part II.B.2 (discussing Inphoto Surveillance, Inc. v. Crowe, Chizek & Co., 788 N.E.2d 216 (Ill. App. Ct. 2003), and CDT, Inc. v. Addison, Roberts & Ludwig, 7 P.3d 979 (Ariz. Ct. App. 2000)).

[9] *See infra* Part II.B.3 (discussing Crowe, Chizek & Co. v. Oil Tech., Inc, 771 N.E.2d 1203 (Ind. Ct. App. 2002)).

[10] A similar disclaimer in *Malpractice I* was cited by a fellow academic in a different field. *See* Robert M. Jarvis, *The Erring Proctor: Admiralty Lawyers and Malpractice Claims,* 31 J. MAR. L. & COM. 407, 408 n.4 (2000). Apparently, I am becoming more known for what I do not know than for what I do.

[11] *See* discussion *infra* Part II.D.2.d (discussing Murphy v. Comptroller of the Treasury, 207 F. Supp. 2d 400 (D. Md. 2002)).

[12] *See* discussion *infra* Part II.D.1.d (examining *In re* Marriage of Bielawski, 764 N.E.2d 1254 (Ill. App. Ct. 2002), which addresses this issue in greater detail).

analyze these professions separately, the pragmatic truth is that the dividing line between the work of the tax attorney and the accountant, at best, has always been murky.[13] It is not possible to separate out the two professions. The dividing line may have become murkier when Congress, in 1998, extended the traditional attorney-client privilege to accountants, as well as to other tax practitioners.[14] There are instances where attorneys and accountants share the role of defendant.[15] In many situations, the defendant-practitioner could just as easily be from one profession as from the other. Given the interchangeability of these two professions in the malpractice area, many courts simply hold both professions to the same malpractice standards.[16]

The results of this update are roughly consistent with the results of *Malpractice I*. The area that seems to generate the most cases, as it did before, is estate planning, or more specifically, the estate and gift tax cases discussed in Part II.D.2. These cases generally involve planning the transmission of property to one's heirs at the least possible tax cost.[17]

The tax shelter area, which generated a relatively large number of cases in *Malpractice I*, was pretty quiet during recent years. However, with the IRS's current aggressive pursuit of investors in tax shelters,[18] a wave of malpractice suits against the accountants and attorneys involved in facilitating or even promoting these unsuccessful shelters seems to be just over the horizon, perhaps to come into full view in five to ten or fifteen years ("Malpractice III" or even "Malpractice IV"?).[19] Beyond the estate planning area, more cases have arisen in the very broad general negligence

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[13] *See, e.g.*, National Conference of Lawyers and CPAs, *Lawyers and Certified Public Accountants: A Study of Interprofessional Relations*, 36 TAX LAW. 26, 27, 30–31 (1982).

[14] *See* Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3411(a), 112 Stat. 685 (1998) (adding new I.R.C. § 7525).

[15] *See, e.g.*, discussion *infra* Part II.D.2.b (discussing Blair v. Ing, 21 P.3d 452 (Haw. 2001) in greater depth).

[16] *See, e.g.*, Hnath v. Vecchitto, No. X03CV930502910, 2003 Conn. Super. LEXIS 1063, at *22 (Conn. Sup. Ct. Feb. 20, 2003); *see also* Todres, *supra* note 1, at 551 n.13.

[17] While the generation skipping transfer tax, codified in I.R.C. §§ 2601–2661, would also seem to belong in this category, to date I have not uncovered any case involving this tax. *But see* Priv. Ltr. Rul. 97-36-032 (June 9, 1997) (ruling on the potential future use of the generation skipping transfer tax exemption for taxpayers who were in the midst of suing their former accountants for failing to allocate the exemptions to trusts they set up for the plaintiffs' children); Martin D. Begleiter, *First Let's Sue All the Lawyers – What Will We Get: Damages for Estate Planning Malpractice*, 51 HASTINGS L.J. 325, 361–62 (2000).

[18] *See supra* note 6 and accompanying text.

[19] *See, e.g.*, *infra* Part II.D.1.e(1) (discussing *Sommerville v. Hochman Salkin & DeRoy*, No. G030625, 2004 Cal. App. Unpub. LEXIS 1624 (Cal. Ct. App. Feb. 24, 2004), and *Lofton v. KPMG, L.L.P.*, No. 02-81166-CIV, 2002 U.S. Dist. LEXIS 26909 (S.D. Fla. Sept. 10, 2003); *see also* Sheryl Stratton, *Clients Sue E&Y and Three Law Firms Over Tax Shelter*, 97 TAX NOTES 1649, 1649, 1652–53 (2002) (describing another case that is not yet reported).

areas, including late filing, non-filing and negligent preparation, than in any other specific area. As before, only a relatively small number of cases address the issue of what types of damages are recoverable, and much work remains to be done in this area.

Before presenting the results of this study in Part II, Part I will briefly review some elementary background principles, such as the elements of the malpractice cause of action and the measure of damages. Concluding observations will follow.

I. BACKGROUND PRINCIPLES

A. *Elements of a Malpractice Cause of Action*[20]

Civil actions for tax malpractice are usually based on either traditional tort or traditional contract theories.[21] Under traditional tort principles, a professional has a duty "to exercise the level of skill, care and diligence . . . [normally] exercised by other members of the profession under similar circumstances," whereas traditional contract principles impose the obligation to perform the task undertaken diligently and competently.[22] In practice, these two standards, though emanating from different areas of the law, are virtually identical. The professional, therefore, must exercise reasonable competence and diligence to avoid malpractice exposure.[23]

While the basic standard of care is almost identical under tort and contract theories, other aspects of the causes of action and/or defenses thereto may differ depending on which theory is utilized. Differences are usually encountered in the statute of limitations (both how long and when it commences), the measure of damages, to whom liability extends (i.e., privity), and evidentiary matters, such as the need for expert testimony.[24] Several recent cases underscored that differences remain between the two theories and the need to carefully comply with the requirements of each theory. For example, in *Sorenson v. H&R Block, Inc.*,[25] the court denied recovery under a number of different tort theories, while permitting recovery under a contract theory.[26] In *Tony Smith Trucking v. Woods &*

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[20] This section is adapted from *Malpractice I.* Todres, *supra* note 1, at 552–53.

[21] BERNARD WOLFMAN ET AL., STANDARDS OF TAX PRACTICE § 601.1 (5th ed. 1999).

[22] *Id.*

[23] *Id.*

[24] *Id.* at 426.

[25] No. 99-10268-DPW, 2002 U.S. Dist. LEXIS 18689 (D. Mass. Aug. 27, 2002), *aff'd*, 2004 U.S. App. LEXIS 17723 (1st Cir. 2004); *see infra* Part II.B.1.

[26] *Sorenson*, 2002 U.S. Dist. LEXIS 18689, at *19–42. The alleged torts included negligence, breach of fiduciary duty, professional malpractice, intentional/negligent infliction of

Woods, Ltd.,[27] the plaintiffs attempted to qualify for the longer five-year contract statute of limitations instead of the three-year tort statute by arguing that a contract was formed when their accountant signed the power of attorney form to represent them at the IRS audit. The court rejected this argument and held a contract exists only if a specific promise or undertaking is present. If the allegation is simply of a breach of the general duty to act diligently, the claim is for negligence, not for breach of contract.[28]

Normally, the malpractice tort asserted against an attorney is a specific application of the ordinary tort of negligence. The attorney must act as a reasonably competent and careful professional would act under similar circumstances.[29] Since tax law generally is perceived as a specialty, the standard of care may be higher than in other attorney malpractice situations.[30] To establish a prima facie cause of action, a plaintiff must show: "(1) a duty owed by the attorney to the plaintiff . . . ; (2) breach of that duty . . . ; (3) injuries suffered by the plaintiff; and (4) a proximate cause between the injury suffered and the attorney's breach of duty."[31]

The standards for accountants are similar to those for attorneys. Accounting is a learned profession and practitioners must act as would a reasonably competent and careful member of the same profession under the same circumstances. The elements of the prima facie cause of action against the accountant are the same as those listed above against an attorney.[32] Many cases simply equate the elements of the causes of action and the standard of care in accountant and attorney situations.[33]

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emotional distress and intentional or negligent misrepresentation. *Id.* at *3–4. In addition to obtaining recovery under a breach of contract claim the plaintiff also recovered under the state's, (Massachusetts) Unfair and Deceptive Trade Practices Act. *Id.* at *58, 61–62.

[27] 55 S.W.3d 327 (Ark. Ct. App. 2001); *see infra* Part II.C.

[28] *Tony Smith Trucking*, 55 S.W.3d at 331.

[29] WOLFMAN ET AL., *supra* note 21, § 601.2.1.

[30] *See id.* § 603.3; *see also* 3 RONALD E. MALLEN & JEFFREY M. SMITH, LEGAL MALPRACTICE § 23.26 (5th ed. 2000); Todres, *supra* note 1, at 553–54.

[31] WOLFMAN ET AL., *supra* note 21, § 601.2.1 (citations omitted). The essence of the cause of action is comprised of the four elements listed despite the fact that some court sometimes list only three elements. *See, e.g.*, Montes v. Asher & Co., 182 F. Supp. 2d 637, 638 (N.D. Ohio 2002) (listing the elements as duty, breach and injury or damages); Boardman v. Stark, No. 20911, 2002 Ohio App. LEXIS 3790, at *4–5 (Ohio Ct. App. July 24, 2002) (duty, breach and causal connection between the conduct and the damages); Jones v. Bresset, 47 Pa. D. & C.4th 60, 70 (Pa. Ct. Com. Pl. 2000) (listing, duty, breach and proximate cause). Similarly, in other contexts, a fifth element (causation in fact) is added. *See, e.g.*, DAN B. DOBBS, THE LAW OF TORTS § 114 (2001).

[32] WOLFMAN ET AL., *supra* note 21, § 601.2.2.

[33] *See* Todres, *supra* note 1, at 551 n.13; *see also* Hnath v. Vecchitto, No. X03CV930502910, 2003 Conn. Super. LEXIS 1063, at *22 (Conn. Sup. Ct. Feb. 20, 2003)

Nevertheless, there are differences between the two professions that must be kept in mind. For instance, there might be different statutes of limitations[34] and, since the precise nature of the work each professional is called upon to do may differ, a suit against an attorney and an accountant stemming from the same set of facts might have different outcomes.[35]

While the normal malpractice cause of action involves the tort of negligence, other torts are also encountered. *Sorenson v. H&R Block, Inc.*,[36] is a good illustration, containing, in addition to negligence and breach of contract claims, allegations of breach of fiduciary duty, professional malpractice, intentional or negligent infliction of emotional distress, breach of covenant of good faith and fair dealing, intentional or negligent misrepresentation, and false and deceptive trade practices under state law.[37] Alleged violations of federal securities laws[38] and RICO violations[39] may also arise.

Since the tort of negligence is normally encountered in tax malpractice cases, unless specifically indicated otherwise, it will be assumed herein that this is the tort alleged.

B. Measure of Damages

The general tort measure of damages, which also applies in malpractice situations, allows a plaintiff to recover for all injuries proximately caused by the defendant's negligent conduct. The plaintiff may recover the difference between his or her present economic position and the position he or she would have been in absent the negligence.[40]

All damages caused are recoverable, even indirect or consequential damages, as long as they are the proximate result of the defendant's negligence.[41] However, most courts do not award damages for emotional pain and suffering where, such as in the malpractice area, the basic injury

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(adopting same accrual of cause of action date for accountant as for attorney).

[34] *See, e.g.*, Inphoto Surveillance, Inc. v. Crowe, Chizek & Co., 788 N.E.2d 216, 218 (Ill. App. Ct. 2003) (interpreting Illinois' "statute of repose" applicable to accountants, 735 ILL. COMP. STAT. 5/13-214.2 (West 2002)).

[35] For example, see *Blair v. Ing*, 21 P.3d 452 (Haw. 2001), in which the cause of action against the attorney was permitted to proceed (no privity/lack of standing defense rejected) while the cause of action against the accountant was not permitted to proceed (no-privity defense accepted). *See also infra* Part II.D.2.b (discussing *Blair* in more detail).

[36] No. 99-10268-DPW, 2002 U.S. Dist. LEXIS 18689 (D. Mass. Aug. 27, 2002).

[37] *Id.* at *3–4. There was also an allegation of loss of consortium. *Id.*

[38] WOLFMAN ET AL., *supra* note 21, § 605.2.3; Todres, *supra* note 1, at 634.

[39] 3 MALLEN & SMITH, *supra* note 30, § 23.26.

[40] WOLFMAN ET AL., *supra* note 21, § 605.1.1; Todres, *supra* note 1, at 643–45.

[41] *See* WOLFMAN ET AL., *supra* note 21, § 605.1.2.

suffered is only an economic one.[42] To be recoverable, the damages must be actually incurred, not merely speculative ones that may arise in the future.[43] Additionally, under appropriate circumstances, a plaintiff is entitled to recover punitive or exemplary damages.[44] The normal duty generally recognized to mitigate damages resulting from a defendant's negligence is also applicable.[45] Similarly, under the so called "American Rule," attorney's fees incurred to bring the malpractice action are not generally recoverable.[46] Such nonrecoverable litigation costs should be distinguished from normally recoverable consequential damages, such as attorney or accountant fees and other costs incurred to correct, or attempt to correct, the effects of the defendant's negligence.[47]

II. ANALYSIS

A. Preliminary

1. Duty of Competence

Before turning to the main focus of this article—the substantive tax areas that have generated malpractice cases and the correct measure of damages—malpractice liability due to the breach of the duty of competence should be reviewed. During the last five years, there have not been any dramatic developments in this area. The cases seem to follow the reasonably well established principles discussed in *Malpractice I*,[48] though normal development and refinement have continued. In the area of the mere error in judgment rule, an alternative approach mentioned in *Malpractice I*[49] has been followed in its own state and in another, but it is yet too early to call it a trend.

The general duty of competence requires the tax practitioner—whether attorney or accountant—to meet the minimum competency level of his or her profession and "to exercise the skill, knowledge and ordinary care exercised by other members of their profession under similar circumstances."[50]

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[42] *Id.*; *see, e.g.*, McCulloch v. Price Waterhouse L.L.P., 971 P.2d 414, 422 (Or. Ct. App. 1998).

[43] *See* WOLFMAN, ET AL., *supra* note 21, § 605.1.1.

[44] *Id.* § 605.1.3.

[45] *Id.* § 605.2.2.

[46] *Id.* § 605.1.1.

[47] *Id.*; *see also* Todres, *supra* note 1, at 644.

[48] *See* Todres, *supra* note 1, at 553–70.

[49] *See id.* at 559 (discussing Williams v. Ely, 668 N.E.2d 799 (Mass. 1996)).

[50] *Id.* at 553; *see also* WOLFMAN ET AL., *supra* note 21, § 603.

If a professional holds her or himself out as possessing expertise in a field recognized as requiring special skills beyond those of an ordinary member of the profession, she or he will be held to a higher standard of care. Such a standard requires a professional to exhibit similar levels of skill and diligence as others in the same specialty.[51] Tax law is one such professional field that has been "recognized as . . . requiring the higher level of the 'specialist's' skill."[52] Recent cases have continued to apply these standards.[53]

An important basic assumption of the higher standards is that they apply to professionals; i.e., to a member of a learned profession. In *Leather v. United States Trust Co.*,[54] the First Department of the New York Appellate Division affirmed the lower court's decision to dismiss the professional malpractice and breach of fiduciary duty causes of action, and affirmed the refusal to dismiss the plaintiff's breach of contract cause of action.[55] In affirming the dismissal of the malpractice and breach of fiduciary duty claims against the defendant, which was a financial planning company, the court pointedly stated:

> We add that plaintiff makes no showing that defendants were engaged in a "profession," i.e., "an occupation generally associated with long-term educational requirements leading to an advanced degree, licensure evidencing qualifications met prior to engaging in the occupation, and control of the occupation by adherence to standards of conduct, ethics and malpractice liability."[56]

In short, the defendant was not a "professional."

Similarly, in *Sorenson v. H&R Block, Inc.*,[57] in dismissing several of the tort causes of action against the defendant, the court noted that neither H&R Block nor the individual defendant, who was a Block employee, were "professionals;" that is either attorneys or accountants.[58] Thus, the court found no authority under relevant Massachusetts law that created a

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[51] *See* WOLFMAN ET AL., *supra* note 21, § 603.3; Todres, *supra* note 1, at 553–54.

[52] *See* Todres, *supra* note 1, at 554.

[53] *See, e.g.*, Pytka v. Gadsby Hannah, L.L.P., No. 01-1546 BLS, 2002 Mass. Super. LEXIS 461, at *19 (Mass. Super. Ct. Nov. 12, 2002); *see also* discussion *infra* Part II.D.1.b.

[54] 279 A.D.2d 311, 720 N.Y.S.2d 448 (1st Dep't 2001); *see also* discussion *infra* Part III.D.1.e.(3) (examining *Leather* in greater detail). Another case discussed herein in which the primary defendants were neither attorneys nor accountants is *Finderne Management Co. v. Barrett*, 809 A.2d 857 (N.J. Super. Ct. 2002), as discussed in Part II.E.5. Here, however, a CPA was a third party defendant.

[55] *See Leather*, 279 A.D.2d at 311–12, 720 N.Y.S.2d at 449.

[56] *Id.* at 311, 720 N.Y.S.2d at 449–50 (quoting Santiago v. 1370 Broadway Assocs., 264 A.D.2d 624, 624–25, 695 N.Y.S.2d 326, 326 (1st Dep't 1999)).

[57] No. 99-10268-DPW, 2002 U.S. Dist. LEXIS 18689 (D. Mass. Aug. 27, 2002).

[58] See the extensive discussion of *Sorenson infra* Part II.B.1

fiduciary duty as a matter of law between a return preparer and his client.[59] Furthermore, there was no state law that even recognized a professional malpractice cause of action against a return preparer.[60]

At the other end of the spectrum is *Pytka v. Gadsby Hannah, L.L.P.*,[61] in which malpractice was committed by an of-counsel at defendant's law firm, who was not a member of a state bar.[62] Since both the individual and the law firm deliberately and consciously held the individual out as an attorney, he was subject to the liability of an attorney.[63] Moreover, since the individual was held out as a specialist in a wide variety of corporate law specialties, he was "held to the higher standard applied to specialists in those areas."[64]

The mere error in judgment rule, however, assures that the law does not impose upon professionals an implied guaranty of result. In fact, "it is well settled that where a practitioner's judgment concerning a doubtful or unsettled area of law is based on adequate research and careful consideration of the matter, the fact that the judgment turns out to be incorrect will not give rise to a cause of action for negligence."[65]

Malpractice I recognized that Massachusetts took a different approach to tax malpractice in *Williams v. Ely*.[66] Under *Williams*, "the client must be advised of the unsettled status of the law and given the opportunity to knowingly assess the risks and knowingly elect from among available alternative courses of conduct." Failure to so advise clients results in malpractice.[67] This approach has been followed in Massachusetts[68] and adopted by Nebraska.[69]

2. Scope of Engagement

Whenever any professional is retained, a clear, definitive agreement delineating the precise scope of the services to be rendered is most

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[59] *Sorenson*, 2002 U.S. Dist. LEXIS 18689, at *19.

[60] *See id.* at *31.

[61] No. 01-1546 BLS, 2002 Mass. Super. LEXIS 461 (Mass. Super. Ct. Nov. 12, 2002). *Pytka* is discussed *infra*, Part II.D.1.b.

[62] *Id.* at *5, 7–8.

[63] *Id.* at *19, 27.

[64] *Id.* at *19.

[65] WOLFMAN ET AL., *supra* note 21, § 603.5; *see also* Blair v. Ing, 21 P.3d 452, 464 (Haw. 2001) ("An attorney cannot be held liable . . . for an error as to a question of law on which reasonable doubt may be entertained by well-informed lawyers.").

[66] 668 N.E.2d 799 (Mass. 1996).

[67] *Id.* at 806; Todres, *supra* note 1, at 559.

[68] *See, e.g.*, *Pytka*, 2002 Mass. Super. LEXIS 461, at *19.

[69] *See, e.g.*, Wood v. McGrath, North, Mullin & Kratz, P.C., 589 N.W.2d 103, 106–07 (Neb. 1999).

important. *Jones v. Bresset*[70] illustrates the benefit of such an agreement. *Jones* arose out of a series of Chapter 11 bankruptcy filings by the plaintiff, his partner, and their partnership. A number of attorneys were involved in these bankruptcy actions. The present litigation was a malpractice suit against the fifth, sixth, and seventh attorneys.[71]

Bresset, the fifth attorney, was the primary target of the malpractice action. The complaint alleged, among other things, that he withdrew the plaintiff's objections to IRS claims without the plaintiff's consent, and that he failed to assure the plaintiff's tax returns were filed in a timely manner by the accountants retained by Bresset.[72] Other defendants were the sixth attorney, Sayers, who had been hired for tax advice regarding plaintiff's obligations to the IRS,[73] and the seventh attorney, Murray, who had been hired solely "to obtain an accounting in the Bankruptcy Court from Bresset."[74] In an obvious attempt to overcome statute of limitations obstacles in the case against Bresset, the plaintiff charged his subsequent attorneys with failure to advise the plaintiff of the possibility of a malpractice action against Bresset.[75] However, Murray's representation was limited "to obtaining an accounting from Mr. Bresset," and expressly provided it would not extend to any other causes of action.[76] Further, in subsequent correspondence, Murray reiterated the extent of, and limitations upon, his representation.[77] Based on this evidence, Murray obtained summary judgment dismissing the complaint.[78]

In *Estate of Fitzgerald v. Linnus*, the defendant attorney was similarly absolved of liability.[79] Here, the plaintiff sought to recover damages, alleging that the defendant negligently failed to advise him of the tax savings obtainable by means of a qualified disclaimer.[80] The evidence disclosed that the attorney was specifically retained for other services but not to render tax or financial advice to the plaintiff. Furthermore, the attorney advised plaintiff to obtain such advice elsewhere.[81] The

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[70] 47 Pa. D & C.4th 60 (Ct. Com. Pl. 2000).

[71] *Id.* at 61–63.

[72] *Id.* at 66.

[73] *Id.* at 63.

[74] *Id.* at 63–64.

[75] *Id.* at 66–67. Murray was also charged with failing to advise plaintiff of a possible cause of action against Sayers. *Id.* at 67.

[76] *Id.* at 63.

[77] *Id.* at 63–64.

[78] *Id.* at 74–75.

[79] 765 A.2d 251 (N.J. Super. Ct. 2001); *see infra* Part II.D.2.c.

[80] *Estate of Fitzgerald*, 765 A.2d at 253; *see infra* Part II.D.2.c (discussing qualified disclaimers).

[81] *Estate of Fitzgerald*, 765 A.2d at 255.

attorney's motion for summary judgment dismissing the complaint was therefore granted.[82]

Unlike the attorneys in *Jones* and *Estate of Fitzgerald*, who had clearly delineated representation agreements and therefore avoided a trial, the defendant accountant in *Hunter's Ambulance Service, Inc. v. Shernow*[83] was not so fortunate. In *Hunter's Ambulance Service*, the plaintiff corporation alleged that the defendant accountant, Shernow, participated in the corporation's decision to settle a malpractice case against a previous accountant for $35,000 and negligently failed to alert the corporation to the true magnitude of its potential tax exposure, which ran into the hundreds of thousands of dollars.[84] Shernow claimed that he did not participate in the decision to settle but, instead, was simply informed of the decision after it had been reached.[85] Though Shernow was ultimately victorious, the issue of his involvement in the settlement agreement required a trial, as there was no clearly delineated engagement arrangement.[86]

Cohen v. Shaines[87] also illustrates the importance of defining the precise scope of an attorney's engagement. *Cohen* arose in a very unusual context. Here, it was not the client who sued the tax advisor; rather, it was the client's accountant who sued the client's attorney for contribution based upon a breach of duty owed by the attorney to the client.

In *Cohen* defendant attorney, Shaines, was the long-standing attorney for Mrs. Levy and her closely held corporation. In the late 1980s, following the death of Mrs. Levy's husband, Shaines became more involved in her estate planning decisions, which included the transfer of stock in her corporation by Mrs. Levy to her son.[88] These transfers exhausted almost all of Mrs. Levy's unified estate and gift tax credit.[89] By 1993, Mrs. Levy's corporation owed her approximately $900,000. The plaintiff, Cohen, who was Mrs. Levy's certified public accountant, proposed capitalizing these loans for estate planning purposes.[90] In July

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[82] *Id.* at 253.

[83] 798 A.2d 991 (Conn. App. Ct. 2002).

[84] *Id.* at 994–95.

[85] *Id.* at 999.

[86] *Id.* at 998–99.

[87] No. 00-396-M, 2001 U.S. Dist. LEXIS 6370 (D.N.H. 2001).

[88] *Id.* at *1–4.

[89] *Id.* at *4. During the relevant time period, under the estate and gift tax laws, a unified credit was available that enabled a taxpayer to transfer $600,000, either by gift or at death, without incurring any gift or estate tax. *See* I.R.C. §§ 2010, 2505 (1994) (current version I.R.C. §§ 2010, 2505 (2000 & Supp. I 2001)).

[90] *Cohen*, 2001 U.S. Dist. LEXIS 6370, at *4–5. While the court does not give any details of the proposal, presumably the loan was to be forgiven and treated as a contribution by Mrs. Levy to the corporation.

1993, Mrs. Levy, Cohen and Shaines attended a meeting in Shaines' office to discuss Cohen's proposal. The proposal's efficacy depended on the availability of Mrs. Levy's unified credit, which Shaines allegedly knew was already utilized and not available. Notwithstanding this knowledge, Shaines remained silent and acquiesced in the proposal. In due course, the decision was effectuated and Cohen prepared tax returns for Mrs. Levy and her corporation reflecting the capitalization of the loans. In 1996, the IRS audited Mrs. Levy's 1993 tax returns and determined that the loan capitalizations constituted taxable gifts by Mrs. Levy. In the absence of the unified credit, Mrs. Levy paid approximately $135,000 in additional taxes and interest.[91] She filed a malpractice suit against her accountant, Cohen, who settled with Mrs. Levy, but then commenced this action against Shaines for contribution.[92]

The theory behind Cohen's action for contribution was that Shaines had a duty to advise Mrs. Levy that Cohen's proposed loan recapitalization would not work because Shaines was Mrs. Levy's long-standing attorney who had previously given Mrs. Levy the tax-related, estate planning advice that exhausted her unified credit. By remaining silent, Shaines breached this duty and—together with Cohen's own negligence in not determining whether a unified credit was available—proximately caused the additional taxes and interest.[93]

Shaines' defense was that he was not retained to advise Mrs. Levy with respect to Cohen's loan capitalization proposal.[94] Despite Mrs. Levy's affidavit in support of Shaines's position,[95] the court did not grant Shaines' motion for summary judgment.[96] Ultimately, the court was troubled by the fact that the meeting at which Cohen's proposal was discussed occurred in Shaines' office and Shaines attended the meeting, but there was no explanation for his presence.

With no indication in the record of "[w]hy Shaines attended the meeting, the nature of his role at the meeting, and the scope of his legal engagement," the court held Shaines was not entitled to summary judgment.[97] The obvious lesson of this case is that a clear and precise

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[91] *Id.* at *1–6.

[92] *Id.* at *6.

[93] *Id.* at *6–7.

[94] *Id.* at *10.

[95] *Id.* at *10–11.

[96] Shaines actually moved to dismiss for failure to state a cause of action. However, since materials beyond the complaint were introduced the motion was treated as one for summary judgment. *Id.* at *1–2.

[97] *Id.* at *18–19.

agreement specifying Shaines' scope of engagement might have resulted in summary judgment and the avoidance of a trial.

B. Tax Return Preparation/Filing

1. In General

Sorenson v. H&R Block, Inc.,[98] is a diabolically fascinating case. The crux of the complaint involved a Block employee who reported his suspicions to the IRS[99] that the plaintiff planned to file fraudulent 1993 income tax returns before the returns were actually filed. In addition, during the federal audit of this return, the Block employee allegedly disclosed internal Block documents revealing prior concerns about the validity of these tax returns. Allegedly as a consequence of this conduct, the plaintiff was subjected to state and federal tax audits for several tax years that resulted in substantial payments of additional taxes and penalties, and the plaintiff was also subject to a federal criminal investigation.[100] The suit against Block and the employee for $5 million ensued.

The facts of the case were as follows. The plaintiff, Sorenson, in early March 1994, went to a local Block office in Massachusetts for preparation of his 1993 state and federal income tax returns. Sorenson was a client of Block's for approximately twenty years, but had only used this particular branch office for the last three years. At the conclusion of his consultation, the return preparer informed Sorenson that she would forward some potential problem areas to her superiors before the return could be signed and filed.[101] The preparer then sent a memorandum to the Block district manger, Karl Brandenburg, raising concerns over whether Sorenson could deduct expenses of his political campaign for a position on the town planning board, and whether Sorenson's donation to charity of food from a cancelled wedding was deductible. In a later telephone conversation, a third concern regarding a claim for employee business expenses was raised.[102]

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[98] No. 99-10268-DPW, 2002 U.S. Dist. LEXIS 18689 (D. Mass. Aug. 27, 2002), *aff'd*, No. 03-2268, 2004 U.S. App. LEXIS 17723 (1st Cir. 2004). The discussion herein is based on the district court's opinion which is much more extensive and analytical than the First Circuit's which essentially affirmed the district court on all points.

[99] *Id.* at *2. There is an indication in the case that the Massachusetts Department of Revenue was also notified, but most of the discussion in the case concerned only notification of the IRS. *Id.* at *48 n.16.

[100] *Id.* at *2–3, 12.

[101] *Id.* at *4–5.

[102] *Id.* at *5.

While not overly concerned about the deductibility of the donated food or employee business expenses, Brandenburg was convinced that the campaign expenses were not deductible. The local office supervisor subsequently notified Sorenson that the campaign expenses could not be taken as a miscellaneous deduction, and Sorenson then sought to deduct these expenses as charitable contributions.[103]

Upon learning this, Brandenburg himself contacted Sorenson to explain that the campaign expenses were not deductible under either category. Sorenson reacted by placing a call to Block's headquarters to complain. After hearing of Sorenson's call, Brandenburg contacted his supervisor, Block's regional administrator Linda Murphy, to express his adamant opposition to any deduction for the campaign expenses. Later that day (March 14, 1994), however, Murphy told Brandenburg to file the return as Sorenson had requested after a Block researcher deemed the deductions permissible.[104]

On March 15, 1994, Brandenburg sent Murphy a memorandum affirming his position that the campaign expenses deduction was prohibited, opining that as it stood the return constituted "Fraud in capital letters."[105] Attached to the memorandum was a draft letter to Sorenson requesting further documentation for the campaign expenses, the donated food, and the employee business expenses.[106]

Again, Murphy instructed Brandenburg to "drop the matter now," and the draft letter was not sent. Sorenson's return was electronically filed by Block the next day, March 16, 1994.[107]

The IRS's Criminal Investigation Division was contacted on March 15, 1994, the day before the return was filed, and received information regarding Sorenson's "questionable deductions."[108] While the evidence did not conclusively show that Brandenburg contacted the IRS, it seemed highly probable that he made the call.[109]

In July 1994, scarcely four months after Sorenson's 1993 tax returns were filed, the Massachusetts Department of Revenue issued a notice of audit to Sorenson for his 1991 to 1993 tax returns. The audit determined that Sorenson was actually a resident of New York, not Massachusetts as he had claimed, and he should not have deducted certain business

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[103] *Id.* at *5–6.
[104] *Id.* at *6–7.
[105] *Id.* at *7.
[106] *Id.* at *7–8.
[107] *Id.* at *8.
[108] *Id.* at *12.
[109] *Id.* at *13–15. The plaintiff acknowledged that there was a genuine material issue as to whether Brandenburg made the call. *Id.* at *15.

expenses. Over $8300 in additional taxes, interest and penalties were assessed.[110]

In June 1995, the IRS notified Sorenson that it would audit his 1993 tax return. Brandenburg accompanied Sorenson to at least two meetings with the IRS. According to Brandenburg's deposition testimony, he met with the auditor outside of Sorenson's presence shortly before the first meeting and showed the auditor some internal Block memoranda concerning Sorenson's 1993 tax return, including the memorandum that characterized the return as "Fraud in capital letters."[111] Brandenburg further testified he did this "in order to protect Block's own interests in the matter,"[112] and that at a subsequent meeting with the auditor, when asked for a paper copy of Sorenson's 1993 return, he handed over to the agent a file containing not only the return but also Block's internal memoranda.[113]

Eventually, the IRS audit expanded to include Sorenson's 1992, 1994, and 1995 returns. Later the IRS also undertook a criminal investigation of Sorenson. Ultimately, no criminal charges were brought against Sorenson and the case was settled for over $46,400 in back taxes, interest, and penalties.[114]

Sorenson then brought this action against Block and Brandenburg for $5 million. The complaint alleged three distinct wrongs committed by the defendants: (1) filing incorrect federal and state tax returns; (2) breaching a duty of confidentiality by reporting Sorenson's suspected fraud to the IRS before the 1993 return was filed; and (3) breaching confidentiality by voluntarily providing the IRS with internal Block documents during Sorenson's IRS audit, which disclosed concerns regarding the 1993 return.[115] As grounds for relief, the plaintiff alleged a violation of Massachusetts's False and Deceptive Trade Practices Act, negligence, breach of fiduciary duty, professional malpractice, intentional or negligent infliction of emotional distress, breach of contract, breach of covenant of good faith and fair dealing, and intentional or negligent misrepresentation.[116]

The instant case arose on motions for summary judgment by both parties. While the court granted summary judgment to Sorenson, it was on the very limited grounds that Block's voluntary disclosure to the IRS

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[110] *Id.* at *8.

[111] *Id.* at *8–9.

[112] *Id.* at *9.

[113] *Id.*

[114] *Id.* at *10–11.

[115] *Id.* at *11–12. *But cf. id.* at *2–3 (where the order is different).

[116] *Id.* at *3–4. There is also a count for loss of consortium by Sorenson's wife, but this is ignored herein as irrelevant to the discussion.

during the audit was a breach of contract, and that Block later committed an unfair and deceptive trade practice. The damages awarded, apart from an unreported amount of attorneys fees under the Massachusetts False and Deceptive Trade Practices Act, were nominal: return of his 1993 tax preparation fees, and double his 1994 and 1995 fees. On all remaining counts, Block was granted summary judgment.[117]

While at first blush it may seem surprising that such egregiously disloyal conduct by a tax preparer towards its client was essentially without meaningful remedy, an analysis of the court's reasoning may alter one's view.

The district court commenced its analysis with an examination of the plaintiff's breach of fiduciary duty claims, and noted that in Massachusetts, no case law supported imposing a fiduciary duty on a tax return preparer to the client as a matter of law.[118] Nor would the court consider the preparer-client relationship as an agency relationship since the preparer had no authority to bind the client, and the client did not have the type of control over the preparer necessary for an agency relationship as, for instance, the client would have had over an attorney.[119] Finally, the court held that, although Massachusetts law recognized the possibility that fiduciary duties might arise in a particular factual situation on an ad hoc basis, no such duty existed here. Under Massachusetts law, "while 'a great disparity or inequality relative to the other party' may give rise to a fiduciary duty, its breach entails some 'abuse to the benefit of the more powerful party, particularly where unjust enrichment would result.'"[120] Here, the court did not find that Block abused its relationship with Sorenson to gain some meaningful benefit. The only benefits the court could envision Block receiving by the disclosure were either to protect Block from the possible imposition of return preparer penalties or to demonstrate to the IRS that Block had an effective fraud prevention plan in effect. However, neither benefit was substantial enough to support a fiduciary claim. The court, therefore, granted summary judgment to the defendants on these counts.[121]

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[117] *Id.* at *61–63. On appeal, the United States Court of Appeals of the First Circuit noted that the total damages awarded to Sorenson was $630. Sorenson v. H&R Block, Inc., No. 03-2268, 2004 U.S. App. LEXIS 17723, at *3 (1st Cir. 2004).

[118] *Id.* at *19.

[119] *Id.* at *21. Massachusetts follows the Restatement of Agency's definition of agency. *Id.* at *20–21

[120] *Id.* at *24 (quoting Indus. Gen. Corp. v. Sequoia Pac. Sys. Corp., 44 F.3d 40, 44 (1st Cir. 1995)).

[121] *Id.* at *24–26.

Next, the court considered Sorenson's claims of negligence and professional malpractice.[122] Here, too, the defendants were granted summary judgment because the court could not find any relevant legal duty that the defendants breached. According to the court, there was no Massachusetts law that imposed any duty on a tax return preparer that Block violated, neither by the possibility of inaccurate returns, nor by Block's disclosures to the IRS.[123] Thus, a basic element for both negligence and professional malpractice was missing. With respect to professional malpractice, the court noted that Sorenson "cited no Massachusetts statute or case that recognize[d] a professional malpractice cause of action against a tax return preparer," and the court was "disinclined . . . to invent one."[124]

Turning to the breach of contract claim, Sorenson was finally victorious, but in light of the damages awarded, the victory was very Pyrrhic.

Since Sorenson was a long-time customer of Block, the court was willing to treat representations made by Block regarding its accuracy in return preparation and its confidential treatment of return information as contractual obligations.[125] The jacket Sorenson received with his tax returns after they were filed by Block[126] contained these representations: "[y]our return was carefully prepared and checked for accuracy," and "[a]ll the information in your return will be kept completely confidential."[127] Accordingly, while the three grounds alleged by Sorenson in the complaint could have stated good causes of action for breach of contract, only one of the three was ultimately upheld.

Regarding the claim for filing inaccurate tax returns, the court determined that there was no valid cause of action against Block. Under the facts, none of the inaccuracies resulted from errors by Block. The deductions for charitable contributions (including the political expenses) and excessive employee business expenses were clearly insisted upon by Sorenson, despite many expressions of resistance by Block. Likewise, the errors detected by the Massachusetts Department of Revenue audit—

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[122] The Tort claim was asserted in three counts in the complaint: a basic negligence claim against Block and Brandenburg; a claim of negligent failure by Block to investigate/supervise; and a claim of negligent failure by Block to train. *Id.* at *26.

[123] *Id.* at *28–29.

[124] *Id.* at *31.

[125] *Id.* at *32.

[126] The court realized that Sorenson's 1993 tax return was never returned to him so he never received a jacket for this return. In light of Sorenson's long-standing relationship with Block and his receipt of many such jackets prior to 1994, the court ignored this omission. *Id.* at *32, 32 n.10.

[127] *Id.* at *31–32.

misdesignation of the tax home and certain excessive deductions—were likewise not Block errors. The evidence, according to the court, when viewed in a light most favorable to Sorenson, showed that Block simply failed to prevent Sorenson from submitting a tax return containing inaccuracies that Sorenson himself was primarily responsible for. Therefore, the court awarded Block summary judgment on this point.[128]

Sorenson's claim for relief because of Block's report to the IRS of its concerns about the return before it was filed was dealt with by the court rather summarily on evidentiary grounds. Since the evidence left open the material fact regarding whether Brandenberg was the source of the report, the court decided the matter was not appropriate for summary judgment and denied both parties' motions.

Sorenson was fully victorious and received summary judgment on his third claim, that Block voluntarily provided the IRS with its internal documents at the audit of his 1993 return. According to the court, this clearly breached Block's contractual duty of confidentiality to Sorenson and warranted summary judgment Sorenson.[129]

Insofar as his damages were concerned, Sorenson was not very fortunate. The bulk of the damages claimed apparently resulted from emotional distress. Under Massachusetts law, the court held that a plaintiff could not recover damages for emotional distress solely on contractual grounds. While acknowledging that Massachusetts law sometimes made an exception, the court held the exception was not applicable in the present situation. Here, the public policy favoring disclosure of suspected tax fraud to the IRS militated against the award of such damages.[130] Ultimately, the court awarded Sorenson only the preparation fee for his 1993 tax return, holding that there is never any basis to award a plaintiff the amount of unpaid back taxes. These are the taxpayer's responsibility irrespective of how they were discovered.[131] Though Massachusetts law was silent, the court also decided not to award Sorenson interest or penalties incurred. In the absence of a specific contractual undertaking to pay such amounts,[132] the court held it would follow the New York view in *Alpert v. Shea Gould Climenko & Casey*,[133] deeming it the majority

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[128] *Id.* at *37–38.

[129] *Id.* at *41–42.

[130] *Id.* at *43–44.

[131] *Id.* at *45. This is consistent with the general view in such malpractice cases.

[132] Block did contractually promise to pay interest and penalties resulting from an error by Block in the preparation of a tax return. The court held that this undertaking did not apply to Block's promise to keep returns confidential. *Id.* at *45–46.

[133] 160 A.D.2d 67, 559 N.Y.S.2d 312 (1st Dep't 1990).

view,[134] which denied interest recovery since such a recovery would give a plaintiff the "windfall" of having both use of the money as well as the interest.[135] The court similarly refused to award Sorenson attorney's fees incurred in the audits and criminal investigation.[136]

The court expressly noted that Sorenson was only entitled to the preparation fee for his 1993 tax return, notwithstanding that Massachusetts also audited his 1991 and 1992 returns, and the IRS also audited 1992, 1994 and 1995 returns. The breach of confidentiality occurred only with respect to the 1993 return.

In connection with the court's damages award, several observations are offered. Initially, it should be noted that typically in tax malpractice situations, attorneys fees or fees paid to other professionals to fix or attempt to fix the harm caused are recoverable.[137] Second, while the court decided it would not award interest and penalties as damages because it would follow *Alpert*[138] and not give plaintiffs a double benefit[139]—*Alpert* applies only to interest, not to penalties.[140] There is no doubling up with regard to penalties and such amounts could be recoverable.

It appears that the court treated Sorenson as an unsavory tax cheat to whom it awarded as little as legally necessary and nothing more. In addition, the damages awarded were strictly contract damages and not tort damages, which can be more extensive. If Block had engaged in this precise conduct, but with respect to a taxpayer who had legitimate deductions, it would be hard to justify not awarding attorneys fees and also, perhaps, damages caused in other audited years.

Before concluding its analysis, the court granted the defendants summary judgment on Sorenson's allegations of intentional and negligent infliction of emotional distress[141] and intentional and negligent misrepresentation.[142] Essentially, the court held that the plaintiff failed to prove the existence of any cognizable severe emotional distress.[143] Also, to establish a cause of action for intentional infliction of emotional distress under Massachusetts law, a defendant would have had to engage in

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[134] *Sorenson*, 2002 U.S. Dist. LEXIS 18689, at *45–46 (citing Eckert Cold Storage, Inc. v. Behl, 943 F. Supp. 1230, 1235 n.7 (E.D. Cal. 1996)).

[135] *Id.* at *45–46.

[136] *Id.* at *47–48.

[137] *See* WOLFMAN ET AL., *supra* note 21, § 605.1.2; Todres, *supra* note 1, at 564–65.

[138] *See supra* notes 133–35.

[139] *Sorenson*, 2002 U.S. Dist. LEXIS 18689, at *45–46.

[140] *Alpert*, 160 A.D.2d 67, 70, 559 N.Y.S.2d 312, 313 (1st Dep't 1990). The IRS did not assess any penalty in *Alpert*.

[141] *Sorenson*, 2002 U.S. Dist. LEXIS 18689, at *51–57.

[142] *Id.* at *57–58.

[143] *Id.* at *52–58.

"'extreme and outrageous' conduct 'utterly intolerable in a civilized community.'"[144] Raising "a 'hue and cry' regarding suspected tax fraud," according to the court, simply did not establish such conduct.[145]

Sorenson did achieve another victory in the case, albeit a very backhanded and almost fortuitous one. The court granted Block summary judgment[146] with respect to most claims arising under the Massachusetts Unfair Trade Practices Act,[147] specifically holding that while Block's actions may have been in breach of its contract of confidentiality, they nevertheless were not "immoral, unethical, oppressive or unscrupulous" so as to directly violate the Massachusetts law.[148] Nevertheless, the court held Block violated that law by failing to disclose to Sorenson that it breached its duty of confidentiality with respect to his 1993 tax return, when it prepared his 1994 and 1995 tax returns. This omission deprived Sorenson of the opportunity to consider other tax preparation services in light of Block's violation of its duty of confidentially, and constituted an unfair trade practice.[149] The court, therefore, granted Sorenson summary judgment on this issue and awarded him the tax preparation fees for the 1994 and 1995 tax returns as damages. Since there is an important public policy to encourage the reporting of tax misfeasance, the court declined to award more than the minimum double damages under the law.[150] The court, as was required, also awarded reasonable attorneys fees to Sorenson in connection with the prosecution of this action.[151]

For all his trouble, in light of the fact that Sorenson was ultimately a tax cheat, he recovered his tax preparation fees for 1993, double his tax preparation fees for 1994 and 1995, and his attorney fees in this action. On appeal, the First Circuit noted that the total damages awarded to Sorenson were $630.[152]

2. Late Filing and Non-Filing

Failing to file a tax return on a timely basis has been said to comprise "the vast majority of malpractice cases arising in the return preparation

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[144] *Id.* at *53–54 (quoting RESTATEMENT (SECOND) OF TORTS § 46 cmt. d (1965)).
[145] *Id.* at *54 (quoting Roberts v. United States, 445 U.S. 552, 557 (1980)).
[146] *Id.* at *59–60.
[147] MASS. GEN. LAWS ch. 93A, § 2 (2004).
[148] *Sorenson*, 2002 U.S. Dist. LEXIS 18689, at *60–61.
[149] *Id.* at *61.
[150] *Id.* at *61–62.
[151] *Id.* at *62.
[152] Sorenson v. H&R Block, Inc., No. 03-2268, 2004 U.S. App. LEXIS 17723, at *3 (1st Cir. 2004).

context."[153] For instance, in *Haas Enterprises v. Davis*,[154] upon the death of the taxpayer's accountant in 1995, it was discovered that no tax returns were filed for the defendant's professional corporation since 1984.[155] An interesting example of failing to file a timely return occurred in *Brott Mordis & Co. v. Camp*.[156] There, the plaintiff, Camp, had taxes withheld from his pay for 1989, 1990, and 1991, but never filed any tax returns. During July 1992, Camp hired the defendant accountants, Brott Mardis & Co., to prepare his delinquent returns for the three years. However, instead of providing Brott Mardis with all his tax information immediately, he supplied this information piecemeal on an annual basis.[157] Camp delivered his 1991 tax information to Brott Mardis on April 7, 1995. The return was mailed to the IRS on April 15, 1995 and received on April 18, 1995. The refund claimed on the return was denied by the IRS as untimely. Camp later filed this suit against Brott Mardis claiming negligence for failure to timely file the return, which prevented recovery of his 1991 refund.[158]

Interestingly, Camp received summary judgment in the trial court on the assumption that the general three-year statute of limitations applied. Under this theory, the last date to timely file his 1991 return was April 15, 1995, and Brott Mardis was negligent in failing to meet this deadline.[159] In fact, the actual applicable statute of limitations was for two years[160] and had expired on April 15, 1994, almost one year before the 1991 information was turned over to the defendant.[161] On appeal, the trial court's decision was reversed and the defendant was granted summary judgment.[162]

In *Borissoff v. Taylor & Faust*,[163] an estate administrator's attorneys prepared the estate's federal and state estate tax returns, and had a memorandum in their files recognizing that certain deductions were omitted on the original returns. Amended returns, however, were never

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[153] WOLFMAN ET AL., *supra* note 21, § 605.2.1.

[154] 82 P.3d 42 (N.M. Ct. App. 2003).

[155] *Id.* at 43. The *Haas Enterprises* court addressed the procedural issue of when the statute of limitations accrued.

[156] 768 N.E.2d 1191, 1193 (Ohio Ct. App. 2001).

[157] *Id.* at 1192.

[158] *Id.* at 1192–93.

[159] *Id.* at 1193. The trial court was utilizing the general statute of limitations which is three years from the due date (April 15th of the next year) of the return. *See* I.R.C. § 6511(a) (2000).

[160] Section 6511 of the Internal Revenue Code provides that when a tax return is not filed, a claim for refund must be filed within two years from when the tax is paid. I.R.C. § 6511(a), (b)(1). Withheld income taxes are deemed paid on April 15 of the next year. I.R.C. § 6513(b).

[161] *Brott Mordis*, 768 N.E.2d at 1192.

[162] *Id.* at 1196.

[163] 117 Cal. Rptr. 2d 138 (Ct. App. 2002), *rev'd*, 93 P.3d 337 (Cal. 2004).

filed to claim these deductions nor was an extension of time to file an amended return sought.[164] A subsequent executor for the estate brought suit against the attorneys for malpractice. The intermediate appellate court, affirming the trial court, held the executor lacked standing to sue the attorneys for the previous administrator for malpractice since he had no privity with the attorneys.[165] On appeal, the Supreme Court of California reversed on the privity issue and remanded for further proceedings.[166]

Two recent cases involved suits against accountants for failing to advise corporate taxpayers of their obligations to collect sales taxes and file the required tax returns. In *Inphoto Surveillance, Inc. v. Crowe, Chizek & Co.*,[167] the taxpayer, an Illinois corporation which provided surveillance services for the insurance industry, commenced providing such services in New York in 1992. It inquired of the defendant accountants whether it was obligated to collect sales taxes and file sales tax returns in New York. It was erroneously advised that it need not, and in 1999, it paid New York approximately $500,000 as a condition for entering into a voluntary disclosure program.[168]

In *CDT, Inc. v. Addison, Roberts & Ludwig, C.P.A.*,[169] the taxpayer was an Arizona corporation that provided photocopying services in various states, expanding its business into California in 1982. Neither the taxpayer's original accountant, who was employed from 1981 until late 1989 or early 1990, nor the successor ever advised the taxpayer to collect California sales tax and, presumably, to file the required tax returns.[170] In 1996, California assessed $3.2 million against the taxpayer for unpaid taxes, interest and penalties. The taxpayer later instituted this action against both accountants.[171]

While both situations seem to present potentially viable tax malpractice claims, neither court addressed the substance of the claims, focusing instead on statute of limitations issues in the context of either a motion to dismiss or a motion for summary judgment.[172]

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[164] *Id.* at 141.

[165] *Id.* at 146.

[166] 93 P.3d 337 (Cal. 2004), *rev'g*, 117 Cal. Rptr. 2d 138 (Ct. App. 2002).

[167] 788 N.E.2d 216 (Ill. App. Ct. 2003).

[168] *Id.* at 217.

[169] 7 P.3d 979, 980 (Ariz. Ct. App. 2000).

[170] *Id.* at 980.

[171] *Id.* at 981.

[172] In *Inphoto Surveillance*, the trial court had dismissed the defendant's motion to dismiss on statute of limitations grounds and certified for review the question whether an exception to the accountant's statute of repose that refers to "income tax assessments" also applied to sales tax assessment. 788 N.E.2d at 216. The court held it did not. *Id.* at 219. In *CDT*, the Court of Appeals of Arizona reversed summary judgment in favor of the defendant on statute of limitation

One additional case deserves mention. If there were ever a "Chutzpah[173] of the Year" award, the defendant attorney in the following case would win hands down. In *Leasequip, Inc. v. Dapeer*,[174] the defendant-attorney had represented or, perhaps more accurately, misrepresented, the plaintiff in a number of matters for which he faced many potential malpractice claims.[175] In 1994, he advised the plaintiff not to file corporate tax returns since Bank of America refused to furnish an accounting of monies it had extended or received on behalf of the plaintiff. In addition, the defendant advised the plaintiff not to observe any normal corporate formalities, including the filing of a statement of information with California, which resulted in suspension of the plaintiff's corporate powers by the California Secretary of State. The defendant advised the plaintiff periodically between 1994 and 1999 that failure to observe these "mere formalities" was easily curable without affecting the corporation's business or legal claims.[176] The court found that the defendant's true motive in rendering this advice was to make it legally impossible for the plaintiff to pursue any of its potential malpractice claims against the defendant.[177]

On July 16, 1998, the plaintiff's corporate powers were suspended for failing to file the required statement of information. When the plaintiff brought suit for malpractice on October 22, 1998, the defendant successfully dismissed the initial complaint, presumably on the basis of plaintiff's suspended corporate powers. With respect to a subsequent complaint, the defendant argued that by the time the plaintiff's suspended corporate powers had been revived in September 1999, the statute of limitations had expired on most of the malpractice claims.[178]

Fortunately for the American legal system, the California Court of Appeals held that the defendant attorney was equitably estopped from asserting the statute of limitations as a defense to most of the alleged malpractice claims.[179]

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grounds. *CDT*, 7 P.3d at 980.

[173] The classic modern definition of chutzpah is when one who has killed both his parents throws himself at the mercy of the court because he is an orphan. LEO ROSTEN, THE JOYS OF YIDDISH 93 (1958).

[174] 126 Cal. Rptr. 2d 782 (Cal. Ct. App. 2002).

[175] *Id.* at 784–85.

[176] *Id.* at 784.

[177] *Id.*

[178] *Id.* at 785–86.

[179] *Id.* at 792. As a footnote to the defendant attorney's rightful entitlement to the "Chutzpah of the Year" award, it should be noted that during the pendancy of this action he filed a separate suit against the plaintiff for over $400,000 of unpaid legal fees in the underlying (mis)representations which were at the heart of this case. *Id.* at 786.

3. Negligent Preparation

This section will focus on errors involving the return preparation process. There are cases that simply assert malpractice occurred in the preparation of a tax return without specifying the underlying facts or without specifying them in any useful detail.[180] These cases often arise in the context of a motion to dismiss or a motion for summary judgment and, by and large, are ignored herein. Cases that result from the misapplication of a specific tax code provision, deduction, or tax concept will be addressed subsequently in this article.

There are some points in the following two cases that make them worthy of mention, even though these cases fail to specify the underlying preparation problem in enough detail. The first case, *Noel v. Hoover*,[181] involved an appeal from the trial court's dismissal of a complaint against an accountant as barred by the statute of limitations. Allegedly, the accountant incorrectly reported a stock transfer on the taxpayer's 1990 tax return.[182] Of note, the return not only resulted in proposed additional taxes, but in an IRS recommendation of criminal prosecution based on the willful signing of a fraudulent tax return.[183] The amounts involved were substantial,[184] but unfortunately, the opinion provided no additional details about the actual tax return.

In the second of these cases, *Avakian v. Ohanessian*,[185] one of two former partners appealed a grant of summary judgment on statute of limitation grounds to the now dissolved partnership's accountant. The malpractice action alleged that the accountant refused to deduct the salaries paid to most of the partnership's employees. The defendant-accountant claimed that the workers did not file income tax returns, some of the workers were working illegally, and the partnership did not pay payroll taxes and other employer contributions on behalf of those employees.[186] Isn't this a situation likely to be encountered by many accountants who represent small businesses? The moral of *Avakian* is to approach such

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[180] *See, e.g.*, KPMG, L.L.P. v. Carmel Fin. Corp., 784 N.E.2d 1057 (Ind. Ct. App. 2003); Caron v. Smith, No. CV-03-213, 2004 Me. Super. LEXIS 36, at *1 (Me. Super. Ct. Mar. 3, 2004); Alvarado v. H&R Block, Inc., 24 S.W.3d (Mo. 2000).

[181] 12 P.3d 328 (Colo. Ct. App. 2000).

[182] *Id.* at 329.

[183] *Id.*

[184] *See id.* The notice of deficiency demanded an additional $815,589 in taxes plus $611,692 in fraud penalties. *See id.* After a trial in tax court, the additional tax owed was determined to be $488,718 with no liability for any penalties. *See id.*

[185] No. B150367, 2002 Cal. App. Unpub. LEXIS 9275 (Cal. Ct. App. Oct. 3, 2002).

[186] *Id.* at *4.

situations very carefully and thoughtfully—especially where the business has multiple owners.

An interesting additional sidenote to *Avakian* is the claim that the negligently prepared tax return caused the other partner to dissolve the partnership, which, among other things, caused the plaintiff to incur legal expenses.[187] Whether such damages could be recovered in an appropriate case is most intriguing.

In *Crowe, Chizek & Co. v. Oil Technology, Inc.*,[188] the defendant-accountants had prepared the plaintiff corporation's Indiana personal property tax returns from 1987 through 1992. On each of the returns, the defendant accountants had failed to claim an exemption for industrial waste control facilities to which the taxpayer was entitled. As a result, the taxpayer overpaid its personal property taxes by approximately $168,000.[189] On appeal, the Indiana Court of Appeals held that the relevant statute of limitations barred the prosecution of this action.[190]

McCulloch v. Price Waterhouse L.L.P.[191] involved a suit against an accounting firm and an accountant involved in the preparation of estate tax returns. Although the precise errors made by the accountants were not clearly detailed in the opinion, the plaintiff claimed that the returns were not up to acceptable standards of quality, were filed late, were not accepted as filed by the IRS and state authorities, and there was either failure to disclose, or misrepresentation about, whether the returns were accepted as filed.[192] Both sides appealed the jury verdict, and the appellate court addressed two noteworthy damages issues. First, after reviewing the split among the other states concerning recovery of interest assessed against a plaintiff in addition to taxes, the court in *McCulloch* concluded that such interest may be recoverable in Oregon.[193] The court reasoned that there would not necessarily be a double recovery—use of the money plus interest—since such a windfall depends on the financial condition of the plaintiff. Where the plaintiff does not have money available to invest, clearly there will be no double benefit. Similarly, the court did not believe that the nature of the causation of such damages was too speculative to be recoverable. This, according to the court, was within the realm of decisions courts in Oregon have always dealt with.[194]

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[187] *Id.* at *13.
[188] 771 N.E.2d 1203 (Ind. Ct. App. 2002).
[189] *See id.* at 1205.
[190] *Id.* at 1211.
[191] 971 P.2d 414 (Or. Ct. App. 1998).
[192] *See id.* at 419.
[193] *Id.* at 418–19.
[194] *Id.* at 419.

The second damages issue addressed by *McCulloch* was whether damages for emotional distress were recoverable in such malpractice cases. Considering that the underlying injury involved in malpractice cases is purely economic, the court held that no recovery was available for emotional distress under Oregon law.[195]

In *King v. Neal*,[196] the defendant tax attorney prepared the plaintiffs' 1991 income tax return. During 1991, the plaintiffs settled a multi-year dispute with a bank. On their 1991 tax return, the defendant deducted a loss that he concluded was sustained when the dispute was settled, including legal fees and other expenses that had been paid prior to that year. A later audit determined that the plaintiffs could not take these deductions in 1991. However, by then it was too late to file amended returns and claim the deductions in the proper earlier years.[197] The suit against the defendant followed, and a jury awarded plaintiffs damages. On appeal, the major issue was whether the award was excessive.[198]

The damages awarded below consisted of the amounts paid by plaintiffs for additional taxes, penalties, interest and other expenses incurred as a result of the audit (i.e., professional services and representation during the audit), and the fee paid for preparation of the 1991 return.[199] In addition, though the jury did not award any punitive damages, they were instructed about, and presumably considered, them.[200] On appeal, the major issue was whether the additional tax incurred by plaintiffs could properly be awarded as damages.[201]

Without much difficulty, the court in *King* held that it was proper to include in damages the additional tax incurred by the plaintiffs. The governing Oklahoma statute provided that the measure of damages was "the amount which will compensate for all detriment proximately caused . . . whether it could have been anticipated or not."[202] And, according to the court, it was for the jury to decide whether, and how much, to award.[203] Interestingly, in its analysis, the court cited only one case from the federal district court in Louisiana as authority, without any real discussion.[204] Similarly, and again without much discussion, the court

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[195] *Id.* at 421–22.

[196] 19 P.3d 899 (Okla. Civ. App. 2001).

[197] *Id.* at 900.

[198] *Id.* at 900–01.

[199] *Id.* at 900, 902.

[200] *See id.* at 900.

[201] *Id.* at 901.

[202] *Id.* at 902 (emphasis omitted) (quoting OKLA. STAT. tit. 23, § 61 (1991)).

[203] *Id.*

[204] *Id.* at 901 (citing Bancroft v. Indemn. Ins. Co. of N. Am., 203 F. Supp. 49 (W.D. La. 1962)).

distinguished another Louisiana federal district court case relied upon by the defendant.[205]

It should be noted that the measure of damages for the additional taxes utilized in *King* might be incorrect. If the claimed amounts should have been deducted in years prior to 1991, the real loss to the taxpayer would seem to this author to be the value of the foregone tax savings in the proper earlier years. By omitting these deductions from 1991, the correct tax for 1991 was determined. The amount of incorrectly inflated 1991 deductions seems irrelevant to the plaintiff's actual damages. Perhaps the court below simply assumed the 1991 amount was an acceptable approximation of the actual earlier losses.

One final interesting point is mentioned, but seemingly not addressed, in *King*. In affirming that the jury could consider the additional 1991 taxes in determining damages, the court noted that the plaintiffs had testified that "the timing of the additional taxes, interest, and penalties produced an added financial burden that contributed to their filing bankruptcy."[206] It is not clear from the opinion whether the plaintiffs' bankruptcy was, or could have been, an element of the damages awarded by the jury. Would damages caused by a bankruptcy filing, if connected to or resulting from some tax malpractice, be an element of recoverable damages, or would they be too remote?

Cleveland v. Rotman[207] is fascinating, both from its unusual factual setting as well as the court's ultimate holding that suicide is not a foreseeable consequence of bad tax advice. Mr. Cleveland, an attorney, was involved in a fifteen-year tax dispute with the IRS, resulting in numerous trials and appeals. Mr. Cleveland lost all his assets; the IRS even took Cleveland's social security income in the early 1990s; he was disbarred from practicing law; and he went into debt due to the legal bills, interest, and penalties. As a result, Mr. Cleveland suffered severe depression and became suicidal. In 1996, he retained the defendant-attorney for advice in resolving his dispute with the IRS, and the defendant advised Mr. Cleveland to file tax returns for a ten-year period. Mr. Cleveland claimed he was unable to calculate his income and expenses for this period because he lost his financial records in office moves and

[205] *Id.* (distinguishing Gantt v. Boone, Wellford, Clark, Langschmidt & Pemberton, 559 F. Supp. 1219 (M.D. La. 1983), on its facts because, there, tax advice was not sought from the defendant accountant and as a result, he was not liable for malpractice).

[206] *Id.* at 902.

[207] 297 F.3d 569 (7th Cir. 2002).

divorce proceedings. The defendant advised him to estimate his income and expenses for those ten years.[208]

As it turned out, Mr. Cleveland's estimates did not match the IRS figures. The IRS decided to audit him again, despite having previously declared his account uncollectible. The audit was originally scheduled for February 1997, but was postponed until January 1998 after the intervention of Mr. Cleveland's therapist who was concerned over his suicidal tendencies. Mr. Cleveland committed suicide shortly before the audit was scheduled to take place.[209]

Mr. Cleveland's widow, his second wife,[210] instituted a suit on her own behalf and as the executrix of Mr. Cleveland's estate to recover due to Mr. Cleveland's suicide. The claim, insofar as it related to the attorney,[211] alleged that the attorney's advice was flawed because he did not obtain the relevant financial information from the IRS, and told Mr. Cleveland to "guess" at the relevant information for the ten years.[212] Seemingly, the plaintiff claimed that the flawed advice caused the IRS audit, which, in turn, caused Mr. Cleveland's suicide.[213]

The Seventh Circuit affirmed the district court's dismissal of the complaint for failing to state a cause of action.[214] Though several other issues were also involved, the heart of the Seventh Circuit's reasoning was the lack of proximate cause. "[S]uicide is generally not a likely result of bad tax advice, especially when that advice concerns the relatively routine matter of filing tax returns."[215]

4. Miscellaneous—Paying Tax

Leffler v. Mills[216] is a reminder that failing to pay tax timely may also result in a malpractice award. In *Leffler*, defendant attorney was hired to probate a decedent's estate. Though the federal estate tax return was timely filed, he did not timely pay the federal estate tax, resulting in interest and penalties of over $135,000. The trial court granted the

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[208] *Id.* at 571.

[209] *Id.* at 571–72.

[210] *Id.* at 571.

[211] The suit was also brought against the IRS and an IRS officer, but they were not involved in these proceedings. *Id.* at 571.

[212] *See* Cleveland v. United States, No. 00-C-424, 2000 U.S. Dist. LEXIS 18908, at *3–4 (N.D. Ill. Dec. 28, 2000), *aff'd*, 297 F.3d 569 (7th Cir. 2002). The Seventh Circuit's opinion is not very clear on this point. The district court's opinion is more enlightening.

[213] *See id.* at *4–5.

[214] *Cleveland*, 297 F.3d at 575.

[215] *Id.* at 573.

[216] 285 A.D.2d 774, 729 N.Y.S.2d 196 (3d Dep't 2001).

plaintiff summary judgment and awarded this amount as damages.[217] Though this judgment was reversed on appeal because of statute of limitation issues,[218] the damages award likely would have been upheld absent such issues.

C. *Taxpayer Representation Before IRS and Courts*

In *Malpractice I*, a number of cases were discussed in which various litigation-related failings by tax practitioners were the basis for malpractice suits.[219] Such failings occurred in the course of representation before the IRS or in court.[220] Since *Malpractice I*, there were two cases that allege such failings in representing clients before the IRS, but neither explored the underlying facts with meaningful specificity. In *Tony Smith Trucking v. Woods & Woods, Ltd.*,[221] a general allegation claimed that the plaintiffs' accountant failed to exercise the skill and workmanship required by those in the accounting profession with respect to the defense of audits of plaintiffs' income tax returns.[222] This is augmented by the further general claim that the accountant failed to make appropriate arguments or supply appropriate documentation.[223] In *Alvarado v. H&R Block, Inc.*,[224] in addition to a general allegation that defendant negligently prepared the plaintiffs' tax returns, there were allegations that the defendant failed to appear for previously scheduled meetings with the IRS and that an IRS Notice of Deficiency-Waiver form was signed without plaintiffs' authorization.[225] In each case, various statute of limitations issues were the focus of the opinion.

Tony Smith Trucking does focus on an interesting issue. The court considered whether Arkansas's three-year tort statute of limitations, or its five-year contract statute of limitations, was applicable.[226] In an attempt to employ the longer contract statute of limitations, the plaintiffs alleged that a contract was formed when their accountant signed the IRS's power of attorney form to represent them at audit. This, plaintiffs claimed, constituted a contract that was breached by the subsequent deficient

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[217] *Id.* at 775, 729 N.Y.S.2d at 197.
[218] *See id.* at 777, 729 N.Y.S.2d at 199.
[219] *See* Todres, *supra* note 1, at 574–82.
[220] *Id.*
[221] 55 S.W.3d 327 (Ark. Ct. App. 2001).
[222] *Id.* at 328.
[223] *Id.* at 329.
[224] 24 S.W.3d 236 (Mo. Ct. App. 2000).
[225] *Id.* at 239.
[226] *Tony Smith Trucking*, 55 S.W.3d at 329–30.

representation.[227] The court refused to accept this argument and held that to constitute a valid contract, there must be a specific promise or undertaking. If the asserted breach is of the general duty to act diligently, this was simply nothing more than an allegation of negligence. The power of attorney, at most, represents a general duty of the attorney to represent diligently; it does not contain any specific promises and therefore does not rise to the level of a contract.[228]

Frederick Road Limited Partnership v. Brown & Sturm[229] indicated that failing to object to the admissibility of evidence at trial can create the basis for a malpractice suit.[230] The facts of *Frederick Road Limited Partnership* are quite involved.[231] The case arose from estate planning of decedents, Mr. and Mrs. King. At the heart of the matter, the Kings sought to minimize the potential estate and gift taxes to be incurred on the transfer of their farm to their children. The King's accountant believed the farm was worth between $20 and $100 million,[232] but a local real estate attorney, Brown, believed that a much lower value could be placed on the land if a "farm-use only" valuation could be utilized. To justify such a valuation, Brown proposed that the Kings place a three-year "farm-use only" easement on the property.[233] Several farm-use only appraisals valued the farm at between $515,000 and $720,000.[234] When the Kings discussed Brown's plan with their long-time attorney, Wolf, a partner at Piper & Marbury, he strongly disagreed with Brown's plan, calling it "badly flawed."[235] He believed the farm had to be valued at its "highest and best use" and that it was worth much more than the "farm-use only" valuation.[236]

The Kings decided to follow Brown's plan and subsequently sold most of the farm for almost $597,000 to two limited partnerships created by their children. Following Wolf's discharge as the Kings' attorney, he wrote a letter to Mr. King, with a copy to Brown, expressing his concern about the potential tax consequences of the transaction. The letter explained that he believed the farm was worth between $27 and $54.4 million and that substantial additional transfer taxes would be incurred.[237]

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227 *Id.*
228 *Id.* at 330–31.
229 756 A.2d 963 (Md. 2000).
230 *Id.* at 969.
231 *See* discussion *infra* Part II.D.2.d.
232 *Frederick Road Ltd. P'ship*, 756 A.2d at 965.
233 *Id.* at 965–66.
234 *Id.*
235 *Id.* at 966.
236 *Id.*
237 *Id.*

Several years later, after the Kings' death, the IRS investigated the transaction and issued a deficiency assessment of over $68 million in additional taxes and penalties. After Brown's repeated reassurances to the King family that the original transaction was valid and would be upheld, the asserted deficiency was litigated in the Tax Court. Two weeks before the scheduled trial, Brown advised the King children to settle the case for $20 million in taxes and penalties. Brown's sole reason for this advice was that the IRS files contained a copy of Wolf's letter, which Brown believed compromised all his defenses.[238] The King children took Brown's advice and settled for $20 million.

Still not admitting his plan was flawed, Brown convinced the King children to institute a legal malpractice suit against Wolf and his law firm to recover the $20 million. Brown argued that the release to the IRS of Wolf's letter by either Wolf or his law firm violated the attorney-client privilege and was the direct and proximate cause of the $20 million loss.[239] The malpractice suit was terminated when the trial judge granted the defendants' motion for summary judgment,[240] which strongly suggested that Brown caused the King children's damages by his bad advice and failure to object to the admissibility of Wolf's letter before in the Tax Court.[241] The trial judge indicated that Brown could have prevented Wolf's letter from ever coming into evidence "by the slightest exertion of effort."[242]

Unfortunately, the court in *Frederick Road Limited Partnership* never addressed the substance of Brown's liability. It merely held that the courts below erred in granting Brown summary judgment and then reversed and remanded for trial.[243]

In *Lewis v. Edwards*,[244] a doctor with eight felony tax violation convictions sued her attorney in the criminal trial for tax malpractice, asserting that the attorney negligently represented her in the criminal matter. The court, almost summarily, held that in Virginia a plaintiff may not recover unless her convictions were set aside or resolved in her favor as a result of some post-conviction relief granted by a court. Innocence and post-conviction relief are elements of the tort cause of action and it

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[238] *Id.* at 968.
[239] *Id.* at 969.
[240] *Id.* The summary judgment order was affirmed on appeal. *Id.*
[241] *Id.*
[242] *Id.*
[243] *Id.* at 986.
[244] 54 Va. Cir. 257 (Va. Cir. Ct. 2000).

was against Virginia's public policy to allow anyone to receive monetary gain as a result of a crime.[245]

Alampi v. Russo[246] involved a similar situation. The plaintiff, an accountant, pled guilty to a misdemeanor for failing to supply information in connection with an IRS investigation.[247] There too, the plaintiff asserted negligent misrepresentation in the criminal matter, and argued that with more skillful representation, he would have received a better result.[248] The trial judge granted the defendant summary judgment, holding that there was no genuine issue of material fact and that New Jersey "public policy precluded this [type of] action."[249] The appellate court affirmed, holding that the integrity of federal guilty pleas would be undermined if such malpractice suits were permitted where, such as in the present case, the judge carefully determined the existence of a factual basis for the plea before accepting it. Thus, it was against public policy to permit such a malpractice suit.[250] Noting that "whether an unimpeached guilty plea in a criminal proceeding bars recovery in a legal malpractice action" was novel in New Jersey,[251] the court declined to reach the question of whether exoneration from a criminal conviction was always necessary before such a case could reach a jury.[252]

Ang v. Martin[253] held that a defendant in a criminal trial must prove actual innocence of the charged crime, not merely acquittal in the criminal trial, in order to succeed on a claim of legal malpractice allegedly occurring during the criminal trial.[254] The plaintiffs in *Ang* were tried on several criminal charges, including tax fraud. They reluctantly accepted a plea agreement worked out by their attorneys, but after consulting with new counsel, withdrew their guilty pleas and were ultimately acquitted after trial.[255] Subsequently, they instituted this action for legal malpractice against their original attorneys. The Washington Court of Appeals affirmed the trial court's dismissal of the malpractice claim because the plaintiffs could not prove by a preponderance of the evidence that they were not guilty of the underlying crimes.[256]

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[245] *See id.* at 257–58.
[246] 785 A.2d 65 (N.J. Super. Ct. App. Div. 2001).
[247] *Id.* at 66.
[248] *Id.* at 69.
[249] *Id.* at 66–67.
[250] *See id.* at 72–80.
[251] *Id.* at 70.
[252] *Id.* at 72.
[253] 76 P.3d 787 (Wash. Ct. App. 2003).
[254] *Id.* at 790.
[255] *Id.* at 789.
[256] *Id.*

D. *Personal Tax Planning*

1. Income Tax

a. *In General*

Before examining more specific types of potential tax malpractice, I will discuss three cases that do not lend themselves to more precise categorization. The first, *Streber v. Hunter*,[257] involved a combination of bad advice about how to report a transaction and bad advice not to settle the controversy with the IRS on favorable terms. The second case, *Ronson v. Talesnick*,[258] involved erroneous advice concerning the amount of money that needed to be deposited with the IRS in order to stop the running of interest. The third case, *Donahue's Accounting & Tax Service, S.C. v. Ryno*,[259] alleged a failure to file for innocent spouse status before filing a tax return.

Streber claimed egregious misconduct by an attorney, not just with respect to tax matters, but with respect to a series of litigations among family members that the court, with charitable understatement, referred to as "less-than-amicable."[260] The tax malpractice matter concerned advice on how to report the disposition of interests in a joint venture received by two young and financially unsophisticated sisters. The sisters' father, Larry Parker, discovered available undeveloped land in a potentially lucrative residential area. Not having the funds to purchase the land himself, Parker put all the pieces together and got a friend of his to purchase the land as part of a joint venture. For his work in putting the deal together, Parker was to receive a portion of the venture's initial profits, and additionally, a large portion of the venture's equity interest was to be placed in trust for his two young daughters, who were then around sixteen and eleven years old.[261] The equity interest was immediately transferred in trust for the daughters in 1979, and in 1981, the venture sold the property and each of the sisters received $2 million in promissory notes for their interest. In 1982, when the sisters were nineteen and fourteen, respectively, the trustee endorsed the notes and gave both of them to the older sister. In 1985, each sister received $1.7 million and a lot

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[257] 221 F.3d 701, 717 (5th Cir. 2000).
[258] 33 F. Supp. 2d 347, 351 (D.N.J. 1999).
[259] 674 N.W.2d 681, 2003 Wisc. App. LEXIS 1167 (Wis. Ct. App. Dec.17, 2003).
[260] *Streber*, 221 F.3d at 714.
[261] *Id.* at 712.

in the property subdivision in payment of the notes.[262] At issue was the proper tax reporting of the sales proceeds received by the sisters.

By 1985, the sisters were no longer communicating with their father. He had become "infuriated" with them when they refused to invest their proceeds from the notes in his company. Before the fallout, however, Parker advised the older daughter to pay capital gains taxes. The sisters therefore sought tax advice and ultimately retained the defendant attorney, Hunter.[263]

Hunter, after "briefly examining a few documents," and without doing any research, advised the sisters they had three options:

> (1) pay no taxes and hope the IRS did not find out about [it] . . . , (2) treat the transaction as a 1981 gift and pay capital gains taxes on the income received in 1985, or (3) treat the transaction as a 1985 gift, in which case Parker would be liable for gift tax and they would be liable for nothing.[264]

Though option two was clearly the correct one, Hunter urged the sisters to select the third option, insisting that option two would somehow arouse IRS suspicions.[265]

In 1986, Parker's attorney wrote to Hunter expressing his belief that the documents indicated that the gift was made at the inception of the joint venture, not in 1985, and offered to let Hunter examine the documents. Hunter refused.[266]

In 1991, the IRS issued notices of deficiency against both sisters and Parker.[267] Two years later, there was mediation between the sisters, Parker, and the IRS. The trial court found that the IRS would have settled for between $1 and $1.2 million from the sisters. Furthermore, the mediator, a former judge, and Parker's attorney each told the sisters that they would likely lose at trial, and that even if they won, they would nevertheless "'lose' because they would probably be liable for [Parker's] higher gift tax *via* transferee liability."[268] Based on the defendant's reassurance that they would win and that transferee liability was dubious,

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[262] *Id.* at 712–13.

[263] *Id.* at 713.

[264] *Id.* Presumably, option three would also create an income tax liability for Parker on the receipt of the $1.7 million and the lot.

[265] *See id.* at 713–14. In a related tax case the court indicated Hunter "affirmatively advise[d] and vigorously assist[ed]" the sisters in selecting option three. *See id.* at 714 (alterations in original) (quoting Streber v. Commissioner, 138 F.3d 216, 221 (5th Cir. 1998)).

[266] *Id.* at 714–15.

[267] *Id.* at 715.

[268] *Id.* at 715–16. Transferee liability allows the IRS to collect gift taxes from the donee even though liability for the tax is imposed upon the donor. *See* I.R.C. §§ 2502(c), 6901 (2000).

the sisters refused to settle.[269] After the trial, the Tax Court held the sisters liable for the capital gains tax and interest, and imposed penalties for negligence and "substantial underestimation." However, the penalties were reversed on appeal.[270]

The present suit against Hunter was instituted, and, after a jury trial, the sisters were awarded over $2.17 million in damages. The bulk of these damages constituted the difference between the interest charged by the IRS for the sister's late payment of the taxes due and the amount of interest actually earned by the sisters while they had possession of the money.[271] The sisters also received compensation for the time they had spent trying to rectify the harm caused by the defendant.[272]

On appeal, the Fifth Circuit affirmed the judgment in favor of the plaintiffs, though it did modify the damages awarded. Initially, the Fifth Circuit reversed the $97,500 in damages awarded for the time spent by the sisters in attempting to remedy the situation. The Fifth Circuit found that at the charge conference, the trial judge threw out this element of damages. Nevertheless, inexplicably, it appeared in the judge's copy of the jury charge. This was inadvertent, and the amount awarded by the jury should not have been entered as part of the judgment below. The Fifth Circuit therefore vacated this particular award.[273]

With respect to the interest differential award, the Fifth Circuit recognized this as a question of first impression,[274] and noted the existing split in the courts over whether such interest on tax is recoverable in claims of accountant malpractice.[275] The Fifth Circuit noted that courts that do not award such interest reason that a double recovery would result from such an award: the plaintiff would have the benefit of the use of money for a period of time, and then be reimbursed for the interest charged by the IRS for that time. The courts that allow recovery do so, according to the Fifth Circuit, to "make the plaintiff whole."[276]

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[269] *Streber*, 221 F.3d at 716.

[270] *Id.* at 716–17.

[271] *Id.* at 717.

[272] *Id.* Later in the opinion it was disclosed that one sister, Terry, was to receive $97,500 for these "actual damages." *See id.* at 733. The sisters were also awarded substantial additional damages under the Texas Deceptive Trade Practices Act (DTPA). *Id.* at 717. However, the Fifth Circuit reversed this award on the procedural ground that the jury did not separate the actual and punitive portions of the DTPA award. *See id.* at 730–32. Accordingly, it is not discussed herein.

[273] *Id.* at 733–34.

[274] *Id.* at 734.

[275] *Id.* The court also noted that such interest is not awarded as "'actual damages' available for securities fraud claims under Rule 10b-5." *Id.* at 734, 734 n.46 (citations omitted); Todres, *supra* note 1, at 636.

[276] *Streber*, 221 F.3d at 734; *see* Todres, *supra* note 1, at 565; *see also* Caroline Rule, *What*

Based on Texas law, which awards a plaintiff an amount of damages designed to make her or him whole, the Fifth Circuit affirmed the interest differential award.[277] The Fifth Circuit held this was not a double recovery because it only provided the difference between what the taxpayer paid the IRS for use of the money and the actual interest earned by the taxpayer from such money. It simply prevented the taxpayer from being "penalized for conservative investing."[278] Such damages were easily within the realm of foreseeable damages as required by Texas law. Defendant Hunter knew the sisters intended to invest their money conservatively,[279] and the sisters proved the amount of their earnings with great precision.[280]

There is one troubling aspect of the Fifth Circuit's discussion of the interest differential award. The court, as did the district court below, [281] repeatedly referred to the amount of interest on the $1.7 million.[282] The facts, however, indicated that upon the sale of their share in the venture, each sister received $1.7 million and a lot in the subdivision.[283] According to the Tax Court, the tax deficiency asserted by the IRS against each sister was approximately $365,000.[284] The interest charged by the IRS would be based on the additional tax owed, not the full proceeds.[285] Why the Fifth Circuit and the trial court applied the interest differential to $1.7 million is puzzling.

In *Ronson v. Talesnick*,[286] during 1980 through 1983 the plaintiff taxpayer had invested in tax shelter partnerships and claimed losses from the partnerships on his tax returns. Subsequently, the IRS began questioning the deductibility of losses from these partnerships. In mid-1986, the taxpayer sought advice from the defendant accountant on how to stop the accrual of interest on the amount that would be owed to the IRS if these losses were disallowed. The accountant advised the taxpayer to forward a cash bond to the IRS for $91,300, which the taxpayer did on

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and When Can A Taxpayer Recover From a Negligent Tax Advisor?, 92 J. TAX'N 176, 176 (2000) (noting how a "New York taxpayer is not permitted to recover from her accountant interest she owes on an underpayment of tax resulting from the accountant's faulty advice . . . [whereas] a taxpayer in Illinois will be permitted to recover interest").

[277] *Streber*, 221 F.3d at 734–35.

[278] *Id.*

[279] *Id.* at 735.

[280] *Id.*

[281] *Id.* at 717.

[282] *Id.* at 734–35.

[283] *Id.* at 712.

[284] Streber v. Commissioner, 70 T.C.M. (CCH) 1604, 1605 (1995), *rev'd*, 138 F.3d 216 (5th Cir. 1998).

[285] *See* I.R.C. § 6601(a) (2000).

[286] 33 F. Supp. 2d 347 (D.N.J. 1999).

June 30, 1986.[287] In 1996, the IRS audited the taxpayer and it was determined that the cash bond was too low and interest of approximately $235,000 was owed.[288] This suit ensued, seeking to collect from the accountant the additional interest owed by the taxpayer.

The relevant issue in *Ronson* involved the defendant's motion for summary judgment dismissing the action because the plaintiff could not establish any damages. Plaintiff only claimed as damages the interest owed the IRS and, according to the defendant, such interest may never be awarded as damages.[289] In *Ronson*, the court determined that New Jersey law applied,[290] and that New Jersey had no law on point.[291] The court therefore had to determine how the New Jersey Supreme Court would rule on the issue.

Recognizing the split among various jurisdictions on this issue,[292] the court held that New Jersey public policy necessitated that a tortfeasor should not benefit from the ingenuity of a harmed plaintiff, and that such interest be recoverable as damages.[293] According to the court, prohibiting a recovery of interest from a negligent accountant:

> [P]ermits the tortfeasor to benefit from the presumption that a harmed taxpayer has been or should have been ingenious enough to (1) maintain a sum of money that he would have otherwise had to pay over to the IRS and (2) invest that money in a manner in which he earned interest in an amount comparable to the interest rate charged by the IRS.[294]

Although *Ronson* was viewed by *Streber* as simply adopting the view that interest may be recovered as damages in accountant malpractice cases,[295] *Ronson* is actually much more circumscribed. New Jersey follows a benefit rule that, "where a wrong creates a benefit that would not have existed but for the wrong, the damages flowing from the wrong are offset to the extent of the benefit received."[296] Under this rule, the court concluded that the defendant may present evidence of a benefit from the malpractice that could lessen the plaintiff's recovery.[297] Thus, where a plaintiff earned some interest from the tax underpayment, but less than the

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[287] *Id.* at 349–50.
[288] *Id.* at 350.
[289] *Id.* at 351.
[290] *Id.* at 351–52.
[291] *Id.* at 352.
[292] *Id.* at 352–53.
[293] *Id.* at 355.
[294] *Id.*
[295] Streber v. Hunter, 221 F.3d 701, 734, 734 n.47 (5th Cir. 2000).
[296] 33 F. Supp. 2d at 354 (quoting Gracia v. Meiselman, 531 A.2d 1373 (N.J. Super. Ct. Law Div. 1987)).
[297] *Id.* at 355.

amount charged by the IRS, the recoverable damages would be remarkably close to, if not identical with, *Streber*'s interest differential approach.

Further, the particular facts in *Ronson* were not the run-of-the-mill accountant malpractice damages in which, due to the accountant's negligence, the taxpayer owed additional taxes plus interest. Here, the taxpayer specifically sought advice on how to stop the running of interest. If the accountant had done his job diligently, there would be no amount owed to the IRS at all.[298]

In *Donahue's Accounting & Tax Service, S.C. v. Ryno,*[299] the plaintiff accountant sued his client to recover tax return preparation fees. The client counterclaimed, seeking to recover her federal and state refunds for 1999, which were kept by the respective taxing authorities and applied to taxes owed by her former husband.[300] The plaintiff asserted malpractice occurred when her accountant filed tax returns before first filing a request for "innocent spouse" status.[301] The trial court's judgment[302] in favor of the plaintiff was reversed on appeal because she did not introduce any expert testimony on the standard of care owed by an accountant. This standard of care, according to the court, was beyond common knowledge and comprehension and could only be established by expert testimony.[303] The court noted, "It is obvious to this court that the [Internal Revenue Code] is incomprehensible without the assistance of a qualified expert in tax law."[304]

b. *Long-Term Capital Gains*

Pytka v. Gadsby Hannah, L.L.P.[305] presented a classic textbook situation of malpractice where a taxpayer lost long-term capital gains treatment that could have been available with proper planning. The plaintiff obtained over 700,000 shares in his employer on April 1, 1999. In

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[298] *Id.* at 350, 355. Interestingly, the district court could have simply held that interest should be awarded as damages in *Ronson* in light of its unique facts, without deciding that New Jersey would hold that interest is normally recoverable in accountant malpractice cases.

[299] 674 N.W.2d 681, 2003 Wisc. App. LEXIS 1167 (Wis. Ct. App. Dec. 17, 2003).

[300] *Id.* at *2, 5–6.

[301] *Id.* at *5–6. Normally, each spouse is jointly and severally liable for the tax on a joint return. I.R.C. § 6013(d)(3) (2000). In certain instances, where an understatement of tax is due to erroneous items of one spouse of which the other was unaware and had no reason to know, the other "innocent" spouse might avoid liability. IRC § 6015(b).

[302] It is interesting to observe that the suit was brought as a small claims action under WIS. STAT. § 799.209 (2003), and yet an appeal was available. *Donahue's Accounting*, 2003 Wisc. App. LEXIS 1167, at *2–3, 3 n.3.

[303] *Id.* at *8–9.

[304] *Id.* at *6–7.

[305] No. 01-1546 BLS, 2002 Mass. Super. LEXIS 461 (Mass. Super. Ct. Nov. 12, 2002).

late 1999, a large publicly held corporation entered into negotiations to acquire his employer. The purchaser insisted on obtaining all the shares of the employer, including the plaintiff's 700,000 shares.[306] Realizing he had not yet held the stock long enough to qualify for favorable long-term capital gains treatment,[307] the plaintiff retained the defendant law firm, Gadsby Hannah, and its of-counsel, Fineberg, to secure long-term capital gains treatment.[308] While long-term treatment was achievable, the plaintiff sold the shares several days too early due to Fineberg's negligence and affirmative misfeasance.[309] This suit to recover damages ensued. Since Fineberg persistently failed to appear for his deposition, a default order was entered against him.[310] This action, in addition to deciding whether causation was established under Massachusetts law, was an assessment of damages.[311]

Pytka held that the plaintiff could recover as actual damages from the defendant the difference between the actual federal and Massachusetts state short-term capital gains taxes incurred ($656,836), and the amount that would have been incurred if long term capital gains treatment had been achieved ($372,368), amounting to $284,468. The plaintiff was also entitled to recover the $22,000 in legal fees paid to the defendant. In addition, under Massachusetts' Deceptive Trade Practices Act[312] the court awarded plaintiff double the actual damages plus attorney's fees and costs in the present action.[313]

To determine actual damages, the plaintiff argued that the judgment should be grossed-up (i.e., increased) because the judgment itself would be subject to income tax. Therefore, he argued, the judgment should be increased by an amount adequate to insure that the net remaining after tax is equal to the damages suffered by the plaintiff.[314] It is noteworthy that the court specifically declined to add a gross up,[315] though it is unclear if

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[306] *Id.* at *3–4.

[307] Under I.R.C. § 1(h) (2000) (current version at I.R.C. § 1(h) (Supp. III 2003)), as in effect during 2000, the maximum rate of tax on gain from the sale of stock held long term was 20 percent while the maximum rate of tax on ordinary income, including short-term capital gains, was 39.6 percent. I.R.C. § 1(a) (2000) (current version at I.R.C. § 1(a) (Supp. III 2003)).

[308] *Pytka*, 2002 Mass. Super. LEXIS 461, at *5–7.

[309] *Id.* at *13–16, 18.

[310] *Id.* at *1.

[311] *Id.* at *2.

[312] MASS. GEN. LAWS ch. 93A, §§ 2, 11 (1994).

[313] *Pytka*, 2002 Mass. Super. LEXIS 461, at *25–28.

[314] *Id.* at *16–17. The plaintiff's expert calculated this additional amount to be $222,605, based on the plaintiff's tax rate. *Id.* at *17.

[315] *Id.* at *26 n.1.

this was simply because it was not convinced the judgment would be taxable, or for other reasons.[316]

Before leaving *Pytka*, several sidelight aspects of the case are most fascinating and deserve brief mention. It turned out that Fineberg, the "attorney" hired by Pytka was not actually admitted in any jurisdiction.[317] Nevertheless, since he and the firm held him out as a licensed attorney, he was treated as such for liability purposes. The court specifically held that this was appropriate, even though the various tort (i.e., negligence, deceit, negligent misrepresentation, breach of fiduciary duty) and contract claims were based on legal misrepresentation theories.[318] Furthermore, since Fineberg was held out as having special competence in a wide variety of corporate law specialties, he was held to the higher standard applicable to such specialists.[319]

Clark v. Deloitte & Touche L.L.P.,[320] which is discussed in more detail later,[321] also involved the unavailability of long-term capital gains treatment promised to the plaintiffs by their accountant. In *Clark*, the plaintiffs were advised to sell their insurance agency back to the insurance company for a lump sum payment before the end of 1986 in order to obtain favorable long-term capital gains treatment. When long-term treatment was ultimately determined to be unavailable, this suit against the accountant ensued. Unfortunately, the opinion only addressed the statute of limitations and not the substance of the cause of action.[322] The opinion did not disclose whether long-term capital gains treatment may have been achievable by some other disposition.

c. *Litigation Settlement Advice*

In *Naqvi v. Rossiello*,[323] the defendant attorney had represented the plaintiff in a retaliatory discharge action against plaintiff's employer in 1988. That action sought recovery for lost compensation, as well as humiliation, embarrassment, and mental distress. The plaintiff sought both compensatory and punitive damages in equal amounts, but failed to seek separate amounts for each injury.[324] In January 1992, the defendant

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316 *Id.*

317 *Id.* at *7–8.

318 *Id.* at *17–18.

319 *Id.* at *19.

320 34 P.3d 209 (Utah 2001).

321 *See infra* Part II.E.1.

322 *See Clark*, 34 P.3d at 210–11, 218. The court reversed the dismissal of the action by the court below. *Id.* at 218.

323 746 N.E.2d 873 (Ill. App. Ct. 2001).

324 *Id.* at 874–75.

conveyed a settlement offer from the former employer, and advised the plaintiff that the settlement proceeds would be nontaxable. The litigation was then settled.[325]

The settlement neglected to allocate the settlement amount among the specific injuries alleged, or even between compensatory and punitive portions.[326] In 1995, the IRS audited the plaintiff's 1992 tax return and ultimately found that the entire settlement proceeds were taxable. In light of the fact that the settlement agreement contained no apportionment, the IRS simply followed the complaint and treated the settlement as half for punitive damages and half for compensatory damages, ultimately concluding each half was taxable.[327]

The plaintiff then commenced this malpractice action against his attorney alleging that he would not have agreed to the settlement if he had known it was taxable. Further, plaintiff alleged that failing to include an apportionment of the settlement proceeds to the specific injuries constituted negligence.[328]

The trial court agreed with the defendant-attorney and granted summary judgment, reasoning that the advice that the settlement was nontaxable was correct when given,[329] and that the IRS utilized later case law to retroactively treat the plaintiff's recovery as taxable.[330] On appeal, the Illinois appellate court reversed, holding that even when the advice was rendered, the relevant tax law[331] was clear enough for the attorney to have realized that recoveries for different types of injuries were taxed differently: amounts received for embarrassment, humiliation and mental distress were likely nontaxable, while back wages and punitive damages were taxable.[332] Accordingly, the court held enough factual questions existed to warrant a trial.[333]

Jalali v. Root[334] also involved incorrect tax advice given in connection with the settlement of a litigation. In *Jalali*, the defendant

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[325] *Id.* at 875.
[326] *Id.*
[327] *Id.*
[328] *Id.*
[329] *Id.* at 875–76.
[330] *Id.* at 876–77.
[331] I.R.C. § 104(a)(2) (1988 & Supp. I 1989).
[332] *Naqui*, 746 N.E.2d at 880.
[333] *Id.* It is interesting to note that the court's analysis of the different treatment accorded to different types of recoveries would have seemed to presage a holding that there were material issues as to whether the defendant's failure to include any apportionment in the settlement agreement was negligent. Instead, the court concluded that the negligence issue that required a trial was the defendant's advice that the settlement proceeds were nontaxable. *Id.*
[334] 1 Cal. Rptr. 3d 689 (Cal. Ct. App. 2003).

attorney had represented the plaintiff in a suit against her former employer for racial discrimination and sexual harassment. After the first phase of a bifurcated trial, the jury awarded compensatory damages of $750,000 and found the necessary preconditions to justify punitive damages in the second phase. The case was then settled for $2.75 million.[335] In deciding to accept the settlement offer, the plaintiff was advised by the defendant that she would have to pay taxes only on her share of the settlement, after deducting her attorney's fees. In fact, the plaintiff consequently paid taxes on the entire $2.75 million, without any deduction for her attorney's fees.[336] At the malpractice trial, the plaintiff was awarded this difference of $310,000 as damages.[337]

This verdict was reversed on appeal.[338] The ostensible reason for the reversal was that the plaintiff, according to the court, did not establish any damages because she never proved that a higher recovery was possible in the underlying discrimination action.[339]

To this author, however, it appears that the real basis for the California Court of Appeals' decision was the determination that it would be unfair and unjust to impose any damages against the defendant attorney. The basis for this seems to be twofold. First, the court seemed convinced that the attorney obtained a very successful, if not optimal, recovery in the litigation against the plaintiff's employer.[340] As such, the court seems to have discounted the possibility that, even with correct tax advice, the plaintiff would have refused to settle the case for $2.75 million in hopes of obtaining a larger amount after trial. According to the court, the only possible reason for not settling for $2.75 million was the psychic satisfaction of publicly exposing her employer at trial—a non-monetary loss.[341] The second factor that seemed to have motivated the court was that the advice was intuitive; it represented the law in at least three other circuits and was supported by legal commentary.[342] In addition, the correct law was "counterintuitive,"[343] and a seemingly unintended by-product of the enactment of the alternative minimum tax.[344]

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[335] *Id.* at 690.
[336] *Id.* at 692.
[337] *Id.*
[338] *Id.* at 700.
[339] *Id.* at 696.
[340] *Id.* at 690–92.
[341] *Id.* at 693; *cf. id.* at 696–97 (expanding on the psychic issue).
[342] *Id.* at 693–94.
[343] *Id* at 694.
[344] *See id.*

d. Divorce-Related

Divorce is often a very tense, stress-filled, and emotionally charged time, and the parties involved are typically extremely bitter and acrimonious towards one another. This recipe almost guarantees many malpractice suits, particularly since even slight factual deviations could sometimes alter the expected tax consequences.[345] Recently, several additional cases have arisen.

In *Wood v. McGrath, North, Mullin & Kratz, P.C.*,[346] a divorced wife sued her divorce lawyer for allegedly failing to inform her that two issues relevant to her divorce were unsettled under relevant Nebraska law, and that both were resolved against her in the divorce settlement. The first issue, a non-tax issue, involved unvested stock options owned by her husband, and whether they were treated as marital property for purposes of the property settlement. The second, a tax-related issue, concerned whether, for purposes of the property settlement, stock owned by the marital estate should be reduced in value to reflect the more than $210,000 in potential capital gains tax that inhered in the stock.[347] The trial court directed a verdict in favor of the attorney,[348] and the Nebraska Court of Appeals affirmed on the basis of the judgmental immunity rule.[349] Under this rule, when a point of law is unsettled and reasonable doubt may be entertained by well-informed lawyers, an attorney may not be held liable for an error in judgment.[350] On appeal, the Supreme Court of Nebraska reversed, holding that attorneys have a duty to inform clients that the issue is uncertain, thereby allowing clients to make an informed choice among the reasonable alternatives.[351] The court followed *Williams v. Ely*,[352] which adopted this rule in Massachusetts several years earlier.[353]

In re Marriage of Bielawski[354] involved an issue similar to *Wood*. In *Bielawski*, the divorced wife claimed she was not properly advised about how to treat her husband's pension when considering her marital settlement agreement.[355] While the plaintiff sought to vacate the marital settlement agreement—which is not directly relevant to this article's

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345 *See* Todres, *supra* note 1, at 591.
346 589 N.W.2d 103 (Neb. 1999).
347 *Id.* at 104.
348 *Id.* at 105.
349 *Id.*
350 *Id.* at 105–06.
351 *Id.* at 106.
352 668 N.E.2d 799 (Mass. 1996).
353 *Wood*, 589 N.W.2d at 106–07.
354 764 N.E.2d 1254 (Ill. App. Ct. 2002).
355 *Id.* at 1256–58.

focus—it does refer to a malpractice case filed by the wife against her attorney for failure to properly advise her of the tax consequences of treating the pension as income.[356]

Taylor v. Goddard[357] is relevant, though it arises not in a divorce context but from a settlement agreement entered into by two unmarried persons who had been living together in a "meretricious relationship" in Washington State.[358] In addition to raising certain substantive issues, the plaintiff alleged a failure to properly advise about the tax consequences of the settlement agreement.[359] As part of the settlement agreement, one of the plaintiff's corporations would make a $600,000 distribution to the woman and indemnify her for any taxes incurred. The problem, according to the plaintiff, was that he was never advised of the so called "tax-on-tax" consequences.[360] Unfortunately for the plaintiff, the evidence disclosed that the defendant tax attorney actually advised the plaintiff that there was no way to make the $600,000 tax free to the recipient, and that despite his attorney's concerns, the plaintiff "believed that the settlement would be tax free to him and decided to sign the agreement and 'worry about [the recipient's] taxes later[.]'"[361] The court therefore affirmed the lower court's grant of summary judgment for the defendant.[362]

e. Miscellaneous

(1) Tax Shelters/Investments

Sommerville v. Hochman, Salkin & DeRoy[363] involved a legal malpractice suit arising out of investments in a commodities straddle tax

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[356] *Id.* at 1263.

[357] No. 49164-4-I, 2002 Wash. App. LEXIS 2271 (Wash. Ct. App. Sept. 16, 2002).

[358] *Id.* at *1–2.

[359] *Id.*

[360] *Id.* at *3–5. The "tax-on-tax" consequences can be traced back to *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929). In *Old Colony*, the Supreme Court held that if an employer pays the income taxes of an employee pursuant to a contract in which the employer agreed to give the employee certain wages net or free of tax, the income taxes paid by the employer themselves become taxable gross income to the employee. *Id.* at 729–30. To illustrate, assume a tax rate of 50% and that in year one employee is given $1 million of salary "tax free." On April 15 of year two when the employer pays the employee's $500,000 of income taxes for year one, the $500,000 is gross income to the employee. This in turn requires a payment of $250,000 in taxes on April 15 of year three (i.e., fifty percent of year two gross income of $500,000) and so forth. This would continue on for a number of years until the amounts involved approach zero.

[361] *Taylor*, 2002 Wash. App. LEXIS 2271, at *3–4 (alterations in original) (quoting the plaintiff's testimony in the case).

[362] *Id.* at *16–18.

[363] No. G030625, 2004 Cal. App. Unpub. LEXIS 1624 (Cal. Ct. App. Feb. 24, 2004).

shelter, a type of tax shelter popular in the late 1970s and early 1980s.[364] The facts date back to 1980 through 1982 and the court was asked to determine whether the suit was time barred.[365] The plaintiffs were investors who had purchased various positions in commodities based on opinions issued by the defendant law firm and its partner, Salkin, that the losses generated by the program were deductible for tax purposes.[366]

Two types of malpractice were alleged against the defendants. The first type concerned the undisclosed relationship between the attorneys and the brokerage firm that sold the plaintiffs their investment package. The defendant law firm's opinion, which found the promised tax benefits would be available, was presented as if rendered by independent counsel who undertook a disinterested review of the plan.[367] In fact, counsel was neither independent nor disinterested. G. Hunter & Associates, the brokerage firm that sold the plaintiffs the commodities straddle product, was organized by defendant Salkin. Hunter's salespeople were trained in the tax rules of commodities trading by the defendant law firm. Furthermore, the law firm had agreed to: (1) render opinion letters for distribution to potential customers; (2) be involved with any IRS audits of customers concerning the program; (3) prepare a protest for any customer who received a thirty-day letter from the IRS; and (4) bring a test case to establish the validity of the program. The law firm received a commission for every commodities contract traded by Hunter.[368] Also, Salkin and another partner in the defendant law firm created another limited partnership that invested in the same commodities straddle program.[369]

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[364] In the commodities straddle tax shelter a taxpayer would buy one or several contracts for the future delivery of a commodity (the long position). The taxpayer would simultaneously sell an equivalent number of contracts obligating him to delver the same commodity in the future (the short position), but this contract would be due in a different month than the long contract. As the price of the commodity fluctuated either up or down, one of the contracts would typically make money while the other lost money in roughly the same amount. The loss position would then be closed out (perhaps with some machinations involving cancellation rather than purchase or sale) generating the loss sought by the shelter investor. To avoid any economic loss from investing in commodities, the closed position would be replaced by a similar position (either long or short) in the same commodity but with a due date in a different month. If this worked as advertised, substantial losses could be generated for tax purposes without any significant risk. *See generally* Samuel C. Thompson, *An Examination of the Effect of Recent Legislation on Commodity Tax Schedules*, 2 VA. TAX REV. 165, 165–71 (1983).

[365] *Sommerville*, 2004 Cal. App. Unpub. LEXIS 1624, at *21–22 (reversing the trial court's award of summary judgment to the defendants on statute of limitations grounds).

[366] *Id.* at *1–2.

[367] *Id.* at *12, 5.

[368] *Id.* at *3–4.

[369] *Id.* at *5.

The second type of malpractice alleged concerned reassurances that the Hunter program was valid. At the same time the defendants were reassuring the plaintiffs that the program was valid, they were simultaneously warning another favored group of investors that the IRS would likely audit all Hunter investors and gave the other group the opportunity to rescind their investment in Hunter programs.[370]

It is an interesting commentary on our legal system that the litigants in *Sommerville* will have yet another day in court on statute of limitations issues on facts that occurred approximately twenty-four years ago.

If *Sommerville* is a straggler from an earlier generation of tax shelters, *Loftin v. KPMG, L.L.P.*[371] is a harbinger of the type of cases that can be expected in coming years in light of the IRS's recent crackdown on the current generation of tax shelters.

In *Loftin*, the plaintiff sold stock in 1997 and 1999 and netted capital gains of $30 million and $65 million, respectively. Upon depositing the proceeds from the 1997 sale, the plaintiff's banker encouraged plaintiff to retain defendant KPMG for planning purposes in regard to the $30 million capital gain. Plaintiff met with KPMG and was presented with a "FLIP" tax planning strategy.[372] If effective, the FLIP strategy would generate large capital losses, offsetting the capital gains, thereby saving the plaintiff tax on the capital gain. KPMG assured the plaintiff that the FLIP strategy

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[370] *Id.* at *12–13, 13 n.2.

[371] No. 02-81166-CIV, 2002 U.S. Dist. LEXIS 26909 (S.D. Fla. Sept. 10, 2003). *Jacoboni v. KPMG L.L.P.*, 314 F. Supp. 2d 1172 (M.D. Fla. 2004), involved the same type of tax shelter as *Loftin* sold by the same defendant, the big four accounting firm of KPMG, L.L.P., also utilizing a tax opinion of Brown & Wood. However, only *Loftin* is focused on in the text because it describes the underlying tax machinations with some more detail and somewhat addresses the malpractice claim (even if it is just to hold it premature). *See id.* at 1179–81. *Jacoboni*, on the other hand, focused only on whether the plaintiff's RICO claim was precluded by the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995), (holding it was) and then declined to exercise supplemental jurisdiction over the common law fraud and malpractice-type claims, holding they should be litigated in state court. *Id.* at 1173–74.

[372] A "FLIP" strategy is a type of basis-shifting transaction described in I.R.S. Notice 2001-45, 2001-2 C.B. 129. In this type of transaction, an ownership relationship within I.R.C. § 318 is created between a U.S. taxpayer seeking a tax shelter and an entity that is indifferent to U.S. tax consequences, typically a foreign entity. The tax-indifferent entity then purchases stock and subsequently has it redeemed. Under U.S. tax rules, which, in any event, do not apply to the tax-indifferent foreign entity, the redemption is crafted to be treated as a dividend rather than a sale under I.R.C. §§ 302 and 318. Notwithstanding the inapplicability of the U.S. tax rules to the redemption, the U.S. person seeking the shelter argues that under the U.S. tax rules, he nevertheless obtains the tax basis of the tax-indifferent party as though the U.S. tax rules had applied to the redemption. As a result, when the U.S. shelter-seeker sells securities at a price roughly equal to their cost, a large tax loss is reported due to the additional basis purportedly shifted to the securities under § 302 regulations from the related foreign, tax-indifferent party.

It should be noted that *Loftin* also refers to a "BLIP" shelter strategy in the opinion, but never describes the "BLIP" strategy. *Loftin*, 2002 U.S. Dist. LEXIS 26909, at *8–9.

was consistent with IRS rules and regulations and "would withstand an IRS audit."[373] KPMG subsequently delivered its own opinion and the opinion of the law firm Brown & Wood that "the FLIP strategy was 'more likely than not' to be considered proper."[374] The plaintiff decided to utilize the FLIP strategy. He then retained KPMG and another firm that KPMG required him to retain in order to implement the strategy. KPMG was also retained to prepare his 1997 tax return.[375] A similar scenario occurred in 1999 with respect to the plaintiff's 1999 capital gain.[376]

In reality, the FLIP strategy is ineffective. The IRS initiated an audit of the plaintiff's 1997 tax return in October 2000[377] and subsequently issued an announcement challenging the efficacy of such types of transactions.[378] Following these developments, KPMG encouraged the plaintiff to settle with the IRS.[379]

This suit was commenced by the plaintiff against KPMG, Brown & Wood, and the other participants in the FLIP strategy. The complaint included allegations of fraud, breach of fiduciary duty, negligent misrepresentation, malpractice against KPMG and Brown & Wood, and a RICO claim.[380] The majority of the court's opinion in *Loftin* addressed the issue of whether the RICO claim was barred by the Private Securities Litigation Reform Act of 1995.[381] Ultimately, the court held it was barred.[382] The other allegations were held by the court to be premature because Loftin had not yet settled with the IRS, and therefore did not incur damages, an essential element for all of the other causes of action.[383] The court rather pointedly noted that if Loftin's settlement payment is solely for back taxes and interest, there were no damages.[384] This seems a bit extreme to this author since Loftin presumably incurred professional fees (attorneys and/or accountants) during the settlement negotiations as well as transaction costs in effectuating the FLIP strategy, each of which should comprise recoverable damages, if the plaintiff's allegations are proven.

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[373] *Loftin*, 2002 U.S. Dist. LEXIS 26909, at *5.
[374] *Id.* at *7.
[375] *Id.* at *4–5.
[376] *Id.* at *7–8.
[377] *Id.* at *8
[378] I.R.S. Notice 2001-45, 2001-2 C.B. 129.
[379] *Loftin*, 2002 U.S. Dist. LEXIS 26909, at *8
[380] *Id.* at *8–9.
[381] Pub. L. No. 104-67, 109 Stat. 737 (1995).
[382] *Loftin*, 2002 U.S. Dist. LEXIS 26909, at *10–21.
[383] *Id.* at *22–25 (fraud and negligent misrepresentation); *id.* at *25–27 (breach of fiduciary duty); *id.* at *27–29 (malpractice).
[384] *Id.* at *24.

Wiste v. Neff & Co.[385] involved an allegation that an accountant advised a married couple to invest in a tax shelter which later turned out to be defective. In *Wiste*, the investments were made in 1982 and 1983. The final IRS determination that additional taxes amounting to almost $35,000 were owed was received in 1996. By then, the interest and penalties accumulated to over $172,000.[386] The decision focused on when the New Mexico statute of limitations accrued.[387]

Similarly, in *Proskauer Rose Goetz & Mendelsohn L.L.P. v. Munao*,[388] the defendants, as a counterclaim in a law firm's suit to recover legal fees, asserted that the attorneys negligently advised the defendants "they could shelter income through a certain joint venture."[389] In *Proskauer Rose*, the First Department of the New York Appellate Division affirmed the denial below of the law firm's motion to dismiss the counterclaim.[390] In its brief decision, the First Department indicated that in determining the amount of damages, it would be relevant to consider the additional taxes and related expenses incurred by the defendants on account of the law firm's advice as well as any offsetting profits they may have realized from the advice.[391]

Finally, brief note should be taken of *Hnath v. Vecchitto*.[392] In *Hnath*, while having their tax returns prepared, the taxpayers received investment advice from their accountant on two occasions. They followed the advice and purchased the recommended limited partnership interests. Within several years, problems developed with the investments and the taxpayers filed a suit against the accountant.[393] While the case really involved the issue of whether investment advice was proper, it was framed as an accountant malpractice action.[394] The issue before the court was whether the defendant was entitled to summary judgment on statute of limitations grounds. The court denied the defendant summary judgment because the court felt that Connecticut's continuous representation doctrine, used to toll the statute of limitations in attorney malpractice cases, could be

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[385] 967 P.2d 1172 (N.M. Ct. App. 1998).

[386] *Id.* at 1173.

[387] *Id.* at 1176 (holding that the statute of limitations had expired, and affirming the trial court's grant of summary judgment to the defendant).

[388] 270 A.D.2d 150, 704 N.Y.S.2d 590 (1st Dep't 2000).

[389] *Id.* at 150–51, 704 N.Y.S.2d at 591.

[390] *Id.* at 150, 704 N.Y.S.2d at 591.

[391] *Id.* at 151, 704 N.Y.S.2d at 592.

[392] No. X03CV930502901, 2003 Conn. Super. LEXIS 1063, at *1 (Conn. Super. Ct. Feb. 20, 2003).

[393] *Id.* at *1, 16–17.

[394] *Id.* at *3–4.

relevant in light of the similarity between attorney-client and accountant-client relationships.[395] The court, however, declined to address the issue.[396]

(2) Bankruptcy-Related

In *Guillot v. Smith*[397] a taxpayer, who had incurred substantial federal income tax liabilities, filed a Chapter 13 bankruptcy proceeding. Two years later, the taxpayer encountered additional financial problems and could no longer make the planned payments. She was advised by the defendant that if she converted her Chapter 13 bankruptcy plan into a Chapter 7 bankruptcy plan, her tax liability would be discharged, except for $2300. This advice turned out to be incorrect and the taxpayer ultimately sued the attorney for malpractice.[398] The decision did not focus on the substance of the claim, but only on whether the Texas statute of limitations was tolled due to the continued representation of the taxpayer by the defendant attorney.[399]

(3) Pension-Related

In *Leather v. United States Trust Co. of N.Y.*,[400] the plaintiff sued a financial planning company for losses sustained when it failed to advise him "that his pension plan had become fully funded and needed to be rolled over into an IRA in order to avoid excise taxes."[401] The appellate court affirmed the grant of defendant's motion to dismiss for failure to state a cause of action for professional malpractice and breach of fiduciary duty and further affirmed the denial of defendant's motion to dismiss the claim for breach of contract.[402] In the course of explaining its affirmance, the court pointedly noted that the plaintiff failed to show that the defendant financial planning company was engaged in a "profession."[403]

Lewis v. Bank of America N.A.[404] also involved a suit against a financial institution, here a bank and its loan officer, for taxes incurred as a result of bad pension-related advice. In *Lewis*, the plaintiff sought to

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[395] Id. at *22. The continuous representation the plaintiffs alleged was that the defendant accountant continued to prepare the plaintiffs' tax returns for several years after the investment advice was given and until 1992, the year in which this suit was instituted. *Id.* at *16–17.

[396] *Id.* at *22.

[397] 998 S.W.2d 630 (Tex. Ct. App. 1999).

[398] *Id.* at 631.

[399] Id. at 632–33. The court held the statute of limitations was tolled and reversed the lower court's grant of summary judgment to the defendant. *Id.* at 633.

[400] 279 A.D.2d 311, 720 N.Y.S.2d 448 (1st Dep't 2001).

[401] *Id.* at 311, 720 N.Y.S.2d at 449.

[402] *Id.*

[403] *Id.* at 312, 720 N.Y.S.2d at 449–50.

[404] 343 F.3d 540 (5th Cir. 2003).

borrow funds from the defendant bank for use in his son's business. The bank informed plaintiff that it would lend the money only of the plaintiff withdrew the balances from his two pension plans, placed the funds into CDs at the bank, and used these CDs as collateral for the loan.[405] It turned out that the money withdrawn by the plaintiff from his pension plans was taxable.[406] After a jury trial, the plaintiff was awarded substantial damages on his claim that the bank was guilty of breach of contract and fraudulent inducement in causing the plaintiff to incur taxes on the withdrawal of his pension funds.[407] On appeal, the Fifth Circuit reversed the judgment in favor of the plaintiff because the jury in its verdict had found that the bank had agreed to place the funds from the plaintiff's pension plans into "tax-deferred IRA CDs."[408] Unfortunately for the plaintiff, under the relevant tax law,[409] even if the pension funds had been placed in an IRA account, pledging the IRA as security for a loan had precisely the same tax effect as withdrawing the funds from the pension plan and investing them in non-IRA CDs—i.e., the funds become taxable. Accordingly, the breach by the bank did not cause the plaintiff any damages.[410]

2. Estate and Gift Tax Planning

There seems to be a relatively large number of reported malpractice cases in the estate and gift tax planning area. Those involving late-filed returns and allegations of mistakes in the return filing process have been discussed previously[411] and that discussion will not be repeated.

As a general observation, many of the recent cases in this area arise when an heir asserts some failing by either the draftsman of a trust or will or by the counsel or accountant for the estate. Because the heir was never a client of the defendant, many of the cases involve assertions of lack of privity, sometimes presented as lack of standing, as a defense. This and the statute of limitations are the most frequently encountered defenses in this area.

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[405] *Id.* at 543.

[406] *Id.* at 543; *see* I.R.C. § 402 (2000).

[407] *Lewis*, 343 F.3d at 542, 544–45.

[408] *Id.* at 545.

[409] *Id.*; *see* I.R.C. § 408(e)(4).

[410] *Lewis*, 343 F.3d at 545. A majority of the Fifth Circuit panel also held there was inadequate evidence to find the bank guilty of fraud because it had represented that the borrowing by the plaintiff could be accomplished tax-free. *Id.* at 545–47.

[411] *See supra* Part II.B.2–3.

a. Planning Errors

In *Patterson v. Checkett*[412] the defendant attorney had developed an estate plan for the decedent and his wife. The plan required the creation of a non-marital trust by each spouse. Each trust was to be funded with $600,000, the maximum amount that could then be transferred without incurring any estate tax. When the decedent husband died, his trust was underfunded by around $185,000.[413] The primary[414] malpractice allegedly committed by the attorney was failing to insure that each trust was fully funded.[415] After trial, the judge granted the defendant attorney judgment notwithstanding the verdict,[416] which was affirmed on appeal.[417]

While such a failing by an attorney might, in appropriate circumstances, state a good cause of action, it did not in *Patterson*. As an initial matter, due to procedural errors, two of the three points raised by the plaintiffs on appeal were not even considered by the appellate court.[418] As to the third point raised, the court held there was a failure at trial to prove damages.[419]

Factually, the attorney in *Patterson* did not seem to have been negligent. The facts, as summarized by the Missouri Court of Appeals, indicate that the attorney on several occasions informed his clients of the need to fully fund the trust. He also advised them not to fund the trusts with tax deferred assets such as individual retirement accounts or annuities since the transfer of such assets would trigger income tax. Furthermore, the clients had actually advised the attorney that they had finished funding the trusts.[420]

In addition, the case was premature. The primary damages asserted were the extra estate taxes to be incurred on the $185,000 shortfall in the decedent's trust.[421] However, this amount, according to the court, would only be incurred at the death of the surviving spouse, which had not yet occurred. In addition, the court could not determine the actual tax

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[412] 43 S.W.3d 477 (Mo. Ct. App. 2001).

[413] *Id.* at 479–80.

[414] There was also an allegation that during the post-mortem planning, the defendant advised that an inappropriate asset—a tax deferred annuity—be placed in the trust, causing the estate to incur unnecessary tax. *Id.* at 480.

[415] *Id.*

[416] *Id.* at 480.

[417] *Id.* at 482.

[418] The court held that the Appellants (plaintiffs) did not specify any legal reason for the reversal they sought and they waived these arguments by failing to set them forth in the alternative motion for a new trial. *Id.* at 480–82.

[419] *Id.* at 482.

[420] *Id.* at 479.

[421] *Id.* at 480.

consequences because a "charitable aspect of the trusts" would have reduced any tax liability in any event.[422]

A successful allegation of deficient estate planning advice by an attorney is illustrated by *Estate of Nevelson v. Carro, Spanbock, Kaster & Cuiffo*.[423] Here, the defendant law firm had rendered estate planning advice to Louise Nevelson, a prominent sculptor, and her son. The law firm had advised the parties to set up a corporation, owned by the son, which would employ Louise Nevelson and sell her artwork. By this device, it was intended that any artwork owned by the corporation at Ms. Nevelson's death, would remain out of her estate.[424] After Ms. Nevelson's death, the IRS treated the corporation as a sham because Ms. Nevelson had never been adequately compensated by the corporation. As a result, all of the corporation's assets were treated as belonging to Ms. Nevelson's estate and all salary payments made over eleven years by the corporation to Ms. Nevelson's son were treated as gifts by Ms. Nevelson.

The complaint in *Estate of Nevelson* charged that the defendant law firm never advised the plaintiffs of the need to adequately compensate Ms. Nevelson, nor did it warn of the risks attendant upon insufficient compensation.[425] The New York Appellate Division held that these allegations properly stated a cause of action and reversed the summary judgment granted to the defendant law firm by the court below.[426]

Two recent cases suggest that failure to utilize common estate tax saving devices may give rise to recoverable damages in a malpractice suit, though both cases focused on procedural issues. In *Sorkowitz v. Lakritz, Wissbrun & Associates*,[427] the plaintiffs alleged that the defendant attorneys provided estate planning services to the decedents and violated their duties and the required standard of care by failing to include a *Crummey* power[428] in the estate planning documents.[429] The trial court

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[422] *Id.*

[423] 259 A.D.2d 282, 686 N.Y.S.2d 404 (1st Dep't 1999).

[424] *Id.* at 282, 686 N.Y.S.2d at 405.

[425] *Id.* at 283, 686 N.Y.S.2d at 405.

[426] *Id.* at 282, 686 N.Y.S.2d at 405.

[427] 683 N.W.2d 210 (Mich. Ct. App. 2004).

[428] Under I.R.C. § 2503(b) (2000), an annual exclusion from estate and gift taxes is available for certain gifts of a present interest in property. When property is gifted to a trust for future use by or for a beneficiary, the annual exclusion ordinarily would not be available since this would not constitute a present interest in the gifted property. However, if the trust contains a provision that grants the beneficiary a right to immediately withdraw an amount from the trust, this is treated as a present interest in the trust and the annual exclusion is available. This withdrawal right is known as a "*Crummey*" power or right, named after the Ninth Circuit case that approved its use. Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968); *see also Sorkowitz*, 683 N.W.2d at 212 (explaining *Crummey* powers).

[429] *Sorkowitz*, 683 N.W.2d at 211. The complaint also alleged a failure to include necessary

dismissed the complaint for failure to state a claim, accepting defendants' position that under Michigan law "only those who can establish, *without the use of extrinsic evidence*, that a decedent's intent has been frustrated by an attorney's negligent drafting of estate planning documents have standing to pursue a legal malpractice action against that attorney."[430] The trial court held that, since the plaintiffs here needed to resort to extrinsic evidence—i.e., to an expert's affidavit that the use of *Crummey* powers has become standard practice in estate planning and that failure to include a *Crummey* power is unusual and extraordinary—the suit could not proceed.[431] On appeal, the court reversed, focusing solely on this issue. It held that the rule applied by the trial court was inapposite and dismissal of the complaint was incorrect.[432]

In *Coln v. Bush*,[433] the plaintiff, who was the son of the decedent, sued the decedent's attorney and others for failing to create a family limited partnership,[434] which resulted in an additional $1 million in estate taxes.[435] The complaint also contained an allegation that the attorney and others conspired to delay the creation of a family limited partnership.[436] Under relevant California law, in order to assert a cause of action against an attorney for civil conspiracy with his or her client, it was necessary in

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generation-skipping tax language in the estate planning documents, but the case focused only on the *Crummy* power omission.

[430] *Id.* at 212. *See generally* MICH. CT. R. 2.116(C)(8) (detailing Michigan's requirements for a court to grant a summary disposition on stipulated facts).

[431] *Sorkowitz*, 683 N.W.2d at 212–13.

[432] *Id.* at 216.

[433] No. B164613, 2004 Cal. App. Unpub. LEXIS 4257 (Cal. Ct. App. Apr. 29, 2004).

[434] When property is valued for federal estate and gift tax purposes a valuation discount is available when a non-controlling interest in property is involved. The discount reflects the facts that such co-owned property lacks marketability and is a non-controlling interest. To illustrate, assume a business owned by an elderly parent is worth $1 million and that parent gives one-third of the business to each of his or her two children. In valuing the gifts for gift tax purposes, the value of each gift will be less than $333,333, since a partial interest in property is less marketable than a 100% interest. Also, a further discount is available since the interest is less than a controlling, majority interest. Similarly, when the parent dies, for estate tax purposes the retained one third-interest in the business will, for the same reasons, be valued at less than $333,333. In effect, by creating such partial interests in property, the sum of the value of the parts is less, and often substantially less, than the value of the whole, despite the fact that the various interests are owned by related persons, or entities, who may be expected to act together to optimize their respective holdings.

This transfer-tax magic is frequently accomplished by transferring property to a partnership (often a limited partnership) and giving varying interests in the partnership to various family members. Hence, the "family limited partnership." *See generally* Laura E. Cunningham, *Remember The Alamo: The IRS Needs Ammunition in its Fight Against the FLP*, 86 TAX NOTES 1461 (2000).

[435] *Coln*, 2004 Cal. App. Unpub. LEXIS 4257, at *1–2.

[436] *Id.*

certain instances to first obtain a pre-filing order from the trial court.[437] No such order was obtained in this case. The trial court granted the defendants' motion to strike only the conspiracy claim, but not the other claims contained in the complaint. Upon defendants' appeal, the California Court of Appeals addressed only this procedural issue, limiting its affirmation to the trial court's dismissal of the conspiracy claim.[438]

Two other cases involve allegations of bad estate planning advice, though neither case details the facts adequately to understand the precise problem complained of. In *Peterson v. Wallach*[439] the plaintiff was the daughter of a decedent who had retained the defendant attorney to minimize her estate taxes, and, correspondingly, to increase the assets to be received by the plaintiff on her mother's death. Relying on this advice, the mother made inter vivos gifts to the plaintiff in 1990 and 1991 totaling approximately $580,000. The problem, according to the plaintiff, was that these gifts were "added back" into her mother's estate when she died in 1996, allegedly resulting in increased estate taxes of $238,000.[440]

The perplexing aspect of this allegation is that it demonstrates a serious misunderstanding of the basic structure of the estate tax computation. While prior gifts are initially added back to the estate tax computation,[441] there is a subsequent deduction for the tax attributable to such added-back gifts.[442] The net effect is simply to push the amount subject to estate tax to a higher level on the graduated estate tax rate schedule, but not to subject the gifts to multiple taxation.[443] Similarly, if the plaintiff's complaint is simply about being pushed into the higher tax rate bracket, the complaint is also misdirected because retaining the money until death without making a gift would result in incurring the same amount of tax[444] and possibly more if the retained money generated any interest income while held by the donor.

Unfortunately, *Peterson* focuses on a statute of limitations issue and does not focus on the substantive allegation in any more detail.

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[437] *Id.* at 2 (citing CAL. CIV. CODE § 1714.10(a) (Deering 1994)).

[438] *Id.* at 17–18.

[439] 733 N.E.2d 713 (Ill. App. Ct. 2000).

[440] *Id.* at 714–15.

[441] *See* I.R.C. § 2001(b)(1)(B) (2000 & Supp. IV 2004).

[442] *See* I.R.C. § 2001(b)(1)–(2).

[443] *See* RICHARD B. STEPHENS ET AL., FEDERAL ESTATE AND GIFT TAXATION ¶¶ 1.02[4], 2.01. (8th ed. 2002).

[444] Since the same rate schedule is utilized for both inter vivos and testamentary transfers, and the tax is cumulative based on all prior transfers, the same cost will be incurred if property is given away during the donor's lifetime or at death, subject though to timing differences. *Cf id.* ¶ 9.03[2].

Similar to the allegation made in *Peterson* is the claim against the defendant attorney in *Boardman v. Stark*.[445] In *Boardman*, a deceased husband had previously established a trust under which his wife was to benefit for her life and with the remainder going to their children. When the husband died in 1985, the defendant filed the federal estate tax return on behalf of the estate. On the return, as would be expected, he made the qualified terminable interest property ("QTIP") election, without which the husband's estate would not have been entitled to a marital deduction for the trust assets.[446] In July 2000, this suit was filed alleging legal malpractice because of the QTIP election.[447] The claim made by the plaintiffs, who were the widow and children of the deceased, was that upon the death of the surviving widow "the QTIP election will have the effect of transferring the property from the trust into . . . [the widow's] taxable estate instead of allowing the property to pass to the . . . children free of any estate taxes."[448] The problem with this allegation is that this is exactly how the QTIP provision is intended to work. In exchange for a marital deduction to the first spouse's estate, the property must be included in the estate of the surviving spouse.[449] The property never could pass to the children free of estate taxes—the property must be taxed at the death of one spouse or the other.

In *Boardman,* the Ohio Court of Appeals affirmed the lower court's grant of summary judgment to the defendant attorney on the grounds that the case was premature. Since the widow was still alive, no damages had yet been incurred.[450] Interestingly, when the plaintiffs moved to stay the proceedings in the lower court until the widow died and the damages become known, the motion was denied.[451]

b. Drafting Errors

In *Rutter v. Jones, Blechman, Woltz & Kelly, P.C.*,[452] the decedent wanted to leave to each of her two housekeepers a remembrance of $5000, and ten percent of the sizeable residue of her estate to certain qualified

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[445] No. 20911, 2002 Ohio App. LEXIS 3790 (Ohio Ct. App. July 24, 2002).

[446] *See* I.R.C. § 2056(b)(7).

[447] *Boardman*, 2002 Ohio App. LEXIS 3790, at *2.

[448] *Id.*

[449] *See* I.R.C. § 2044 (including in the value of the gross estate of a decedent any property in which the decedent took an election based on a qualifying income interest for life). If the surviving spouse transfers the QTIP interest while alive, the tax will be triggered then. *See id.* § 2519.

[450] *Boardman*, 2002 Ohio App. LEXIS 3790, at *6.

[451] *Id.* at *2–3.

[452] 568 S.E.2d 693 (Va. 2002).

charities. The defendant attorneys who drafted decedent's will and created a revocable trust included language that merely suggested the amount to be left to the housekeepers, but left the final amount to the trustee's discretion.[453] Because the bequest to the housekeepers was left to the trustee's discretion, the value of the bequests to the charities was not ascertainable at the decedent's death, and therefore not deductible for federal estate tax purposes.[454] As a result, upon the decedent's death her estate incurred additional estate tax liabilities of almost $664,000.[455]

Although the attorneys clearly erred and substantial damages were obviously present, the Virginia Supreme Court affirmed the dismissal of this action brought by the executor of the decedent's estate against the attorneys.[456] Under Virginia law, a cause of action survives the death of the person owning the cause of action if it "existed" prior to that person's death.[457] One of the necessary elements for a cause of action for legal malpractice in Virginia is the existence of damages.[458] According to the Virginia Supreme Court in *Rutter*, there were no "damages" while the decedent was alive. All the damages—the additional estate tax and associated legal and accounting fees—arose after death. Since no cause of action "existed" while the decedent was alive, nothing survived that could be asserted by the estate's executor.[459]

The result in *Rutter* is quite remarkable! There was certainly a drafting error that caused very substantial and foreseeable damages, yet no remedy was available. In fact, redress would never seem to be available for any similar faulty drafting of estate documents.

If the plaintiff in *Rutter* was out of luck, the plaintiff in *Harmeyer v. Gustafson*[460] could easily feel the deck was irreversibly stacked against her. Here, the defendant attorney prepared irrevocable trusts, which were immediately funded, for the plaintiff and her husband, Gordon, in 1990. Then, in 1994, the defendant prepared a quitclaim deed that transferred the Harmeyers' homestead to certain nieces and nephews while retaining a life estate for the Harmeyers.[461] Gordon Harmeyer died in 1996. The plaintiff then obtained legal advice from a different attorney and subsequently learned that the documents drafted by the defendant were defective and

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[453] *Id.* at 694.
[454] *Id.* at 694; *see* I.R.C. § 2055(a).
[455] *Rutter*, 568 S.E.2d at 694.
[456] *Id.* at 695.
[457] *Id.* at 694–95 (citing VA. CODE ANN. § 8.01-25 (Michie 2000)).
[458] *Id.* at 695.
[459] *Id.*
[460] No. C8-00-1191, 2001 Minn. App. LEXIS 175 (Minn. Ct. App. Feb. 5, 2001).
[461] *Id.* at *1–2.

would increase the estate taxes incurred by the plaintiff upon her death.[462] While the court did not dwell on the nature of the defendant's errors, it appears that the trust documents gave the Harmeyers annual income from the trusts, and the quitclaim deed retained for them a life estate in the transferred homestead. Both of these provisions violate I.R.C. § 2036 and would result in bringing back into the gross estate and subjecting to estate tax some of the property transferred away.[463] The plaintiff instituted this action against the defendant in 1999.[464]

In *Harmeyer*, the Minnesota Court of Appeals affirmed the lower court's award of summary judgment to the defendant on both causes of action. With respect to the defective trusts, the Court of Appeals held that the plaintiff's action was barred by the statute of limitations. In Minnesota the statute of limitations for legal malpractice is six years,[465] and there is no discovery rule for legal malpractice actions that would toll the running of the statute.[466] The court held that the statute commenced in 1990, when the trust documents were signed. At that time, according to the court, damages were incurred because the trusts did not "transfer assets out of the taxable estates of both . . . Harmeyer[s], thereby saving estate taxes."[467] The Harmeyers' ignorance of the problem was irrelevant.[468]

Similarly, with respect to the error on the quitclaim deed, even though the action was timely, the court nevertheless affirmed the dismissal of the cause of action. The court believed that the damages were too "[s]peculative, remote, or conjectural" to permit recovery.[469] Actual damages could not be determined until the plaintiff's death. According to the court, "[a]ttempting to calculate future tax consequences requires speculation as to when Harmeyer will die, what the value of her estate will be, and what the tax law will be at the time of her death."[470] This, said the court, is too speculative to allow any recovery now.

The bottom line for the plaintiff here: if you wait too long the statute of limitations will expire; if you do not wait, you are premature because

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[462] *Id.* at *2.

[463] The value of the gross estate includes property that a decedent gratuitously transferred during his lifetime if he retained for his lifetime either possession of the property or income from the property. I.R.C. § 2036(a)(1) (2000).

[464] *Harmeyer*, 2001 Minn. App. LEXIS 175, at *7.

[465] *Id.* at *1, 4 (citing MINN. STAT. § 541.05(1)(5) (2000)).

[466] *Id.* at *6 (citing Hermann v. McMenomy & Severson, 590 N.W.2d 641, 643 (Minn. 1999)); *see* discussion *infra* Part II.E.5.

[467] *Harmeyer*, 2001 Minn. App. LEXIS 175, at *5.

[468] *Id.* at *6.

[469] *Id.* at *7.

[470] *Id.* at *7–9.

you cannot yet prove any recoverable damages with the required specificity. Result: No redress either way!

In contrast to *Rutter* and *Harmeyer*, the case of *Porter v. Ogden, Newell & Welch*[471] involved a plaintiff who was well able to take care of himself and, as a result, will get his day in court. In *Porter*, a will and trust were prepared by two law firms, the defendants in this action. Under the plan, the settlor of the trust had to include the trust corpus in his estate at death. The trust, denominated as a "double generation skipping trust," was to protect the trust's corpus from further transfer taxation until the death of the grantor's great grandchildren.[472] Under the trust, the settlor's son, Reverend Porter, became a co-trustee. For the trust's purpose to be effectuated, it was essential that Reverend Porter not have a general power of appointment over the trust. If he did have such a power, the trust corpus would be included, and taxed, in his taxable estate.[473]

In 1990, Reverend Porter discovered a potential problem in the trust. One of the paragraphs of the trust provided that the trustee had discretion to distribute trust corpus to a beneficiary for the "welfare" of such beneficiary.[474] As both co-trustee and beneficiary, Reverend Porter had the power to distribute trust corpus to himself for his "welfare." Under relevant federal law, if "welfare" was a limited, ascertainable standard, such a power would not be tantamount to a general power of appointment.[475] However, if "welfare" had no such limits but was wholly discretionary, this power was tantamount to a general power of appointment.[476] The relevant Treasury regulation indicated that a power to distribute corpus for someone's "welfare" was not limited and is treated as a general power of appointment.[477]

Reverend Porter was advised by his law firm that federal law would look to state law to determine whether "welfare" had an ascertainable standard. However, the relevant Florida law was unsettled as to the meaning of the word "welfare."[478]

In order to solve his problem, Reverend Porter successfully lobbied the Florida legislature to change the law to give the word "welfare" a limited, ascertainable meaning. He then obtained a private letter ruling

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[471] 241 F.3d 1334 (11th Cir. 2001).

[472] *Id.* at 1336. It should be noted that current law prevents utilization of such a trust. *See* I.R.C. §§ 2601–2664 (2000 & Supp. IV 2004).

[473] *Porter*, 241 F.3d at 1337; *see* I.R.C. § 2041.

[474] *Porter*, 241 F.3d at 1336–37.

[475] *Id.* at 1336–37; *see* Treas. Reg. 20.2041-1(c)(2) (2004).

[476] *Porter*, 241 F.3d at 1336–37; *see* Treas. Reg. 20.2041-1(c)(2) (2004).

[477] *See Porter*, 241 F.3d at 1337.

[478] *Id.*

from the IRS that the corpus of the trust would not be included in his estate under the revised Florida law.[479] To further protect his interests if Florida ever changed the law again, Reverend Porter obtained a judicial reformation of the trust instrument to eliminate the word "welfare" as a scrivener's error. He then obtained a second private letter ruling from the IRS that the judicial reformation would not cause any adverse tax consequences.[480]

After Reverend Porter's death in 1999, the trustees of his estate brought this malpractice action against the attorneys to recover the costs expended in curing this general power of appointment problem.[481]

The Eleventh Circuit held that under Florida law the costs incurred by Reverend Porter to cure the potential problem were actual damages incurred and that the case was not premature as the district court below held. Accordingly, Reverend Porter, or at least his estate, was entitled to its day in court.

From a jurisprudential vantage, the issue of whether certain costs incurred by Reverend Porter, such as the costs of lobbying the Florida Legislature, are recoverable or are too remote and unforeseeable is most intriguing.[482]

In *Blair v. Ing,*[483] the Hawaii Supreme Court focused extensively on the privity rules and determined whether beneficiaries may bring suit against an attorney who drafted a trust instrument and against an accountant who prepared the estate tax return. The underlying negligence suit involved an allegation that the trust documents were erroneously drafted.

In *Blair*, the parents of the plaintiffs retained Ing, the defendant attorney, in 1988, to create an estate plan for the disposition of their assets. As part of the plan, a revocable living trust was created with the parents as trustees. In 1996, the plaintiffs' father died. Their mother, as executrix of her husband's estate, hired Thayer, the defendant accountant, to prepare the necessary estate tax returns. The plaintiffs' mother died in 1997. The plaintiffs, who were the beneficiaries of the trust, then became successor co-trustees. As co-trustees, they hired different attorneys and accountants to review the trust documents and, presumably, to file the necessary tax returns, etc.[484] The plaintiffs then learned that the attorney who drafted the

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[479] *Id.*
[480] *Id.*
[481] *Id.*
[482] *See id.* at 1339–40.
[483] 21 P.3d 452 (Haw. 2001).
[484] *Id.* at 455–56.

trust made a costly error. Although the documents disclosed the intent to create a bypass trust, the documents failed to include a funding formula to provide for its funding. This ended up costing additional taxes upon the death of plaintiffs' mother in 1997.[485] The plaintiffs also learned that the accountant hired by their mother to prepare the estate tax returns for their father's estate failed to utilize several tax savings techniques such as disclaimers and the unified tax credit, again causing increased estate taxes and diminishing the plaintiffs' inheritance.[486] They then brought this action against both the attorney and the accountant.

After an extensive analysis of the privity rules, the Hawaii Supreme Court decided that the plaintiffs had standing to bring this action against the attorney. However, the court decided they did not have standing to bring this action against the accountant who had been hired only to prepare the tax returns, not to render any estate planning advice.[487]

Anderson v. Glenn[488] involved allegations of a defectively drafted trust. However, the court directed most of its attention to the statute of limitations issue before it and reviewed the substance of the underlying allegation in a most abbreviated manner. In fact, for purposes of the present appeal from the lower court's grant of summary judgment to the defendants, the parties simply assumed the trust was defectively designed.[489]

In *Anderson*, the defendant attorneys prepared an irrevocable trust for Ora and Albert Anderson in 1978. The purpose of the trust was to transfer the Andersons' assets to their heirs while minimizing estate taxes. The trust was funded in 1980 and Albert died in 1983.[490] The trust mandated the payment of all net income earned by the trust to Albert and Ora throughout their lifetimes. Presumably, this was the defective feature of the trust because, under the Internal Revenue Code, property given away is brought back into the gross estate where the donor retained the right to the

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[485] *Id.* at 456. The operation of the bypass trust is described later in this article. *See infra* text accompanying notes 493–99 (discussing Karam v. Kliber, 655 N.W.2d 614 (Mich. Ct. App. 2002)). It should be noted that *Karam* refers to the bypass trust as the family trust.

[486] *Blair*, 21 P.3d at 456. Though the opinion never specifies, it would appear that the gravamen of the complaint against the accountant was that he could have cured the damages caused by the attorney's drafting error by advising their mother to disclaim the amount that was needed to optimally fund the bypass trust. *Id.* at 456–57.

[487] *Id.* at 474–75.

[488] No. 27349, 2002 Ida. App. LEXIS 100 (Idaho Ct. App. Oct. 29, 2002), *aff'd*, 87 P.3d 286 (Idaho 2003).

[489] *Id.* at *3–5 ("[T]he parties d[id] not dispute that the trust instrument was defective in its design . . . .").

[490] *Id.* at *1–2.

income from the property for life.[491] The defect was discovered by the plaintiffs in 1997 and this suit was subsequently instituted.[492] Interestingly, the trust's alleged defects went unnoticed upon Albert's death in 1983.[493]

The case of *Karam v. Kliber*[494] is also included in this portion of the article though the alleged malpractice apparently involved the failure to draft rather than erroneous drafting. To understand *Karam,* one must have a basic understanding of the basic federal estate tax law and estate planning techniques during the relevant years, 1987 to mid-1990s.[495]

The federal estate tax provides a unified credit to each individual, which enables each individual to transfer a certain amount of property free from federal estate tax.[496] During the relevant time period this amount was $600,000.[497] The federal estate tax also has an unlimited marital deduction so that no tax is incurred when property is left to a surviving spouse.[498] Such property will be taxed upon the death of the surviving spouse, subject to the surviving spouse's unified credit. When planning for a married couple who have sufficient assets to be subject to tax, most often the following approach is utilized: at the death of the first spouse a trust is established, referred to in *Karam* as the "family trust,"[499] to which $600,000, the maximum that may be transferred without triggering the estate tax, is transferred. This trust is designed so that it will not be included in the estate of the surviving spouse.[500] The remaining assets are placed in a trust (the "marital trust") for the surviving spouse, which is eligible for the marital deduction.[501] The net result, which the *Karam* court

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[491] *See* I.R.C. § 2036(a)(1) (2000). The opinion also refers to a power of appointment retained by Albert and Ora Anderson in trust, thereby possibly also triggering I.R.C. § 2041. *Anderson*, 2002 Ida. App. LEXIS 100, at *3. However, the first footnote of the opinion indicates that the power retained was not a general power of appointment, thereby taking it out of I.R.C. § 2041. *Id.* at *3 n.1.

[492] *Anderson*, 2002 Ida. App. LEXIS 100, at *3–4.

[493] *See id.* ("The Trust's alleged defects apparently went unnoticed and did not precipitate any estate tax assessment upon Albert's death in 1983.").

[494] 655 N.W.2d 614 (Mich. Ct. App. 2002).

[495] *Id.* at 616–17 (detailing the estate tax ramifications of the unified credit and the marital deduction, and the estate tax benefits of creating a family trust).

[496] I.R.C. § 2010 (1994).

[497] Prior to its amendment, I.R.C. § 2010(a) granted a unified credit of $192,800—the tax corresponding to a transfer of $600,000. *See* I.R.C. § 2010(a) (1994), *amended by* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 501(a)(1)(A), 111 Stat. 788 (1997) (codified at I.R.C. § 2010(a) (2000)).

[498] *See* I.R.C. § 2056(a) (2000).

[499] *Karam*, 655 N.W.2d at 616.

[500] *Id.* at 616–17. Income from these assets and the assets themselves could be made available for the use of the surviving spouse.

[501] *Id.*

refers to as the "normal" approach,[502] is that no estate tax is incurred upon the death of the first spouse and the first spouse's unified credit is fully utilized.

Under certain limited circumstances, a different estate planning strategy may be utilized. Since the estate tax is a graduated tax, with nominal tax rates between fourteen and fifty-five percent during the relevant period,[503] it was sometimes beneficial to split a couple's assets into two equal portions so that half of their assets were taxed upon the death of each spouse. This approach, referred to by the *Karam* court as an "equalization" approach,[504] gives up the benefit of avoiding the payment of any tax when the first spouse dies.

In *Karam*, the decedent's estate plan was drafted in 1987 by an attorney who was now deceased. The estate plan contained an "equalization" approach rather than the "normal" approach. In 1993, the decedent met with a vice president of the defendant bank to review his estate plan. The vice president allegedly described the decedent's estate plan as utilizing the normal strategy. The vice president suggested certain changes be made to the decedent's estate plan. The decedent then contacted the defendant attorney who analyzed his trust as well as the vice president's suggestions and who then drafted the decedent's will and an amendment to the trust. Several additional amendments to the decedent's trust were later drafted by the attorney.[505] When the decedent died in 1997, his trust still followed the equalization approach and this suit against the attorney and the bank ensued. Apparently, though the opinion is not very clear, the plaintiffs allege that the attorney should have, but failed to amend the trust to adopt the normal rather than the equalization approach.

The opinion does not shed much light on the precise nature of the alleged malpractice. The opinion focused on the evidentiary issue of whether extrinsic evidence may be utilized by the plaintiffs since the decedent's trust and will consistently established and followed an equalization approach. The court concluded that resort to extrinsic evidence was not permissible under Michigan law and affirmed the summary judgment granted to the defendants by the trial court.[506]

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[502] *Id.* at 617.

[503] *See* I.R.C. § 2001 (1994) (current version I.R.C. § 2001 (2000)). Under the old I.R.C. § 2001(c)(2) at certain levels above $10 million a five percent surcharge was also imposed. I.R.C. § 2001(c)(2) (1994) (current version I.R.C. § 2001 (2000)).

[504] *Karam*, 655 N.W.2d at 617.

[505] *Id.* at 617–18.

[506] *Id.* at 625.

c. Disclaimers

If a person is to inherit property, and does not wish to accept the inheritance, a rejection of the inheritance by any means other than a qualified disclaimer[507] will result in the person being treated as if she or he made a transfer subject to gift tax.[508] The theory behind this result is that when a means other than a qualified disclaimer is used, what is occurring is the acceptance of the inheritance, followed by a transfer to the ultimate recipient.[509] The same result occurs if a gift is rejected and then passed to another recipient.[510] Three recent cases have recognized that failure to advise a client of the existence of the qualified disclaimer can result in liability for malpractice.[511] One other case has held it did not, at least under the specific facts of that case.[512]

The three cases that held failing to advise a client of the existence of a qualified disclaimer can constitute malpractice are *Sims* v. *Hall*,[513] *Hosfelt v. Miller*,[514] and *Nikas v. Helms*.[515] *Sims* is very straightforward, holding that an attorney who failed to advise about the potential for a qualified disclaimer is liable for the additional taxes incurred.[516] In *Sims* the plaintiff's sister died intestate in January of 1997. Under South Carolina's intestacy laws, all of her sister's assets were inherited by the plaintiff's mother. On September 1, 1997, the plaintiff's mother died.[517] Although a qualified disclaimer could have been made either by plaintiff's mother while alive or until mid-October by plaintiff as the personal representative of her mother's estate, no disclaimer was made. The reason was that the defendant attorney, who was retained by the plaintiff to help her settle her sister's estate and her mother's estate, never advised her about qualified disclaimers. As a result of the failure to disclaim, the sister's assets were included in the mother's estate, and resulted in additional tax liability of

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[507] *See* I.R.C. § 2518(b) (2000); Treas. Reg. § 25.2518-1(b) (2004).

[508] *See* Treas. Reg. § 25.2511-1(c)(1) (2004) ("[A]ny transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or devise employed, constitutes a gift subject to tax.").

[509] STEPHENS ET AL., *supra* note 443, ¶¶ 10.01[2][g], 10.07[1].

[510] *See id.* However, simply rejecting a gift, which does not result in another person getting it, should not have any tax consequences. *See id.* ¶ 10.01[2][g].

[511] Nikas v. Helms, No. B158021, 2003 Cal. App. Unpub. LEXIS 2118, at *2, 9 (Cal. Ct. App. Mar. 5, 2003); Hosfelt v. Miller, No. 97-JE-50, 2000 Ohio App. LEXIS 5506, at *3, 14–15 (Ohio Ct. App. Nov. 22, 2000); Sims v. Hall, 592 S.E.2d 315, 319 (S.C. Ct. App. 2003).

[512] Estate of Fitzgerald v. Linnus, 765 A.2d 251, 260 (N.J. Super. Ct. App. Div. 2001).

[513] 592 S.E.2d 315 (S.C. Ct. App. 2003).

[514] No. 97-JE-50, 2000 Ohio App. LEXIS 5506 (Ohio Ct. App. Nov. 22, 2000).

[515] No. B158021, 2003 Cal. App. Unpub. LEXIS 2118 (Cal. Ct. App. Mar. 5, 2003).

[516] *Sims*, 592 S.E.2d at 317–18.

[517] *Id.* at 317.

over $191,000.[518] The trial court's award to the plaintiff of these additional taxes as damages was upheld on appeal, notwithstanding a challenge raised by the defendant attorney as to an evidentiary issue.[519]

Hosfelt v. Miller is also relatively straightforward. Mr. Schaefer died in January 1995. Mrs. Schaefer, as executrix, retained the defendant attorney, Henderson, to perform services in the administration of her husband's estate. Mrs. Schaefer, who at the time was dying of cancer, also sought advice from Henderson regarding her own estate.[520] Henderson, it is alleged, failed to advise her of the benefits of a qualified disclaimer.[521] Mrs. Schaefer died in December 1995, never having made a disclaimer of assets received from her husband's estate, and never doing anything else to avoid nearly $95,000 of estate tax ultimately incurred by her estate.[522] The lower court granted summary judgment in favor of the attorney because of the lack of privity, but the Ohio Court of Appeals reversed and sent the matter back for trial.[523] While the bulk of the *Hosfelt* opinion dealt with the issue of privity, and whether such a cause of action survived the death of the person receiving the bad advice, the court made three noteworthy observations with respect to damages. First, the court noted that "[a]lthough necessary taxes may not constitute an injury to a client's interests, taxes which could have been avoided by the exercise of the knowledge, skill and ability ordinarily possessed and exercised by legal professionals under similar circumstances can be considered as an injury."[524] Second, in response to the defendant's argument that damages in such cases are purely speculative because there is no way to know the amount of taxes that will ultimately be incurred by the person failing to disclaim, the court rightfully noted that when Mrs. Schaefer died, the amount of avoidable estate taxes actually incurred became known precisely.[525] Finally, the court also noted that other expenses incurred with respect to Mr. Schaefer's estate, such as increased administration costs or

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[518] *Id.* at 317–18.

[519] *Id.* at 318–20. The defendant attorney's primary challenge to the trial court's judgment was that the plaintiff failed to introduce expert testimony to establish the standard of care he owed to the plaintiff. The court, however, found that the defendant, in connection with his prior motion for summary judgment, had admitted that an attorney had a duty to advise regarding the option to execute a disclaimer. *Id.* at 319–20.

[520] Hosfelt v. Miller, No. 97-JE-50, 2000 Ohio App. LEXIS 5506, at *1–3 (Ohio Ct. App. Nov. 22, 2000).

[521] *Id.* at *3.

[522] *Id.* at *4.

[523] *Id.* at *17–18.

[524] *Id.* at *14.

[525] *Id.* at *15.

costs incurred to correct mistaken filings, may also be recoverable.[526] Therefore, *Hosfelt* is entirely consistent with *Sims*, though the only damages involved in *Sims* were the additional taxes incurred.

In *Nikas*, the plaintiff's father had died intestate in 1993. His mother then hired the defendant attorney for estate planning. The court found that one of the attorney's tasks in this regard was to plan to minimize the eventual estate taxes upon his mother's death.[527] The attorney, however, failed to advise plaintiff's mother about a qualified disclaimer that would have permitted the mother to give $600,000 to the plaintiff, free of estate tax.[528]

The issue in *Nikas* concerned the statute of limitations. Although the plaintiff's mother had learned of the attorney's failure in July, 1994, the present malpractice suit was commenced within one year after the death of the plaintiff's mother in April, 2000. The relevant California statute of limitations for legal malpractice required such a suit to be filed by the earlier of either within one year after the plaintiff discovered, or should have discovered, the injury, or within four years of the injury.[529]

In *Nikas*, the plaintiff argued that the statute of limitations was tolled until his mother died in April 2000 with an estate large enough to incur estate taxes. Before such time, he argued, there was no "actual injury" because the damages were too speculative or contingent to support a cause of action since his mother's estate might have decreased to where it incurred no estate tax liability, or the estate tax might have been abolished.[530]

The court, however, rejected the plaintiff's argument and held that actual injury was suffered when the time to file the qualified disclaimer ended. At such time, the plaintiff failed to receive $600,000 tax free. According to the court, the lost opportunity of using this $600,000 constituted damages, even if the mother's estate would later have incurred no estate taxes upon her death. The suit was therefore barred by the statute of limitations.[531]

Estate of Fitzgerald v. Linnus[532] held that the attorney hired to help the plaintiff administer her deceased husband's estate had no duty to

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[526] *Id.* at *17.

[527] Nikas v. Helms, No. B158021, 2003 Cal. App. Unpub. LEXIS 2118, at *1–2 (Cal. Ct. App. Mar. 5, 2003).

[528] *Id.* at *2.

[529] *Id.* at *3 (citing CAL. CIV. PROC. CODE § 340.6 (Deering 2004)).

[530] *Id.* at *6–7.

[531] *Id.* at *8–9.

[532] 765 A.2d 251 (N.J. Super. Ct. App. Div. 2001).

advise her about qualified disclaimers.[533] This case, however, is limited by its facts. Here, the parties had specifically agreed that the attorney would not render any tax or financial planning advice and that the plaintiff would obtain such advice elsewhere.[534] The court left open the possibility that such a duty might exist in other circumstances.[535] In the present case, however, the attorney's retainer agreement specifically eliminated any such duty by the attorney to the plaintiff,[536] and in the absence of a duty, there can be no malpractice.

d. Valuation

Frederick Road Limited Partnership v. Brown & Sturm[537] was previously discussed[538] and that discussion will not be repeated. In *Frederick Road Limited Partnership*, the original malpractice at the heart of the case was the incorrect valuation placed on land owned by Mr. and Mrs. King. The defendant attorney placed an unacceptably low valuation on the land by valuing it for farm-use only, rather than at its unrestricted, highest and best use value. This had been accomplished by the very simplistic, and ineffective, means of having the owners place a three-year easement on the property limiting its use to only farm-use.[539] In *Frederick Road Limited Partnership*, the Maryland Court of Appeals reversed the lower courts' award of summary judgment to the defendant attorney and remanded the case for trial.[540]

Murphy v. Comptroller of the Treasury[541] serves as a reminder that failing to pay adequate attention to valuation issues may result in the imposition of malpractice liability. *Murphy* was an interpleader action to determine who was entitled to a sum of approximately $130,000. The sum was the settlement received in a suit arising out of the defendant attorney's alleged professional malpractice in "negligently valuing the estate's assets and computing the estate's tax liability.[542]

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[533] *Id.* at 260.
[534] *Id.* at 254–55.
[535] *Id.* at 259.
[536] *Id.*
[537] 756 A.2d 963 (Md. 2000).
[538] *See supra* Part II.C.
[539] 756 A.2d at 965–66.
[540] *Id.* at 986.
[541] 207 F. Supp. 2d 400 (D. Md. 2002).
[542] *Id.* at 401.

E. *Business-Related Tax Planning*

1. Sales of Business or Property

In *Clark v. Deloitte & Touche L.L.P.*,[543] the plaintiffs owned an insurance agency, which comprised the bulk of their retirement assets. Nearing retirement, the plaintiffs obtained tax advice from their accountants concerning how to dispose of their insurance agency at the lowest tax cost. The defendants advised them to sell the insurance agency back to the Farmers Insurance Company for a lump sum payment, thereby obtaining favorable long term capital gains treatment. They were also advised to complete the sale before December 31, 1986 since the law would change on January 1, 1987 and the new law would not be as favorable.[544] They followed their accountants' advice and sold the insurance agency back to Farmers Insurance Company on December 31, 1986.

The plaintiffs' treatment of the sales proceeds as long term capital gains was later disallowed by the IRS based upon a 1973 Tax Court case which held that the lump sum payment received upon the sale of an insurance agency to the Farmers Insurance Company was taxable as ordinary income and not as long term capital gains.[545]

After litigating the matter in Tax Court, which upheld the IRS's decision to tax the lump sum payment as ordinary income, the plaintiffs incurred an additional $161,804 in taxes and penalties.[546] The suit for malpractice and breach of contract against the accountants ensued. Unfortunately, the court did not address the merits of the case, but rather focused on whether the Utah statute of limitations barred the action.[547]

BDO Seidman, L.L.P. v. British Car Auctions, Inc.,[548] also involved erroneous advice rendered by an accounting firm in connection with the sale of assets. Although the precise nature of the advice is not clear, the accounting firm advised the client that certain investment tax credits[549] were available to shelter most of the gain to be incurred on the sale of

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[543] 34 P.3d 209 (Utah 2001).

[544] *Id.* at 210.

[545] *Id.* at 210–11 (citing Deal v. Commissioner, 32 T.C.M. (CCH) 216 (1973)).

[546] *Id.* at 211.

[547] After an extensive analysis of when the statute of limitations begins to run in professional malpractice claims, the court held that the action was timely, and reversed the trial court's motion to dismiss. *Id.* at 218.

[548] 745 So. 2d 1082 (Fla. Dist. Ct. App. 1999).

[549] *See generally* JOHN E. DAVIDIAN & JACOB L. TODRES, REDUCING PERSONAL INCOME TAXES: A GUIDE TO DEDUCTIONS AND CREDITS, §§ 14.08[5]–[6], 14.08[8] (6th repl. 1995).

land.[550] The advice turned out to be incorrect and the client sued to recover the additional taxes and other costs it had incurred.[551] Although the plaintiff was successful at trial, the Florida Court of Appeals reversed, holding that the relevant Tennessee statute of limitations barred the action.[552]

In *Spencer v. Sommer*[553] the plaintiff alleged that she relied on advice given to her by the defendant attorney, and consequently sold property on unfavorable terms. The property belonged to the plaintiff's father, who had already contracted to sell it to one of the defendant's clients. Due to various complications, the sale had not yet been consummated at the time of the father's death in 1989. In 1990, the plaintiff negotiated a new contract with the same client on less favorable terms than she presumably could have received from other potential buyers. The plaintiff based her decision on the defendant's advice that the client could enforce the initial contract, and that such enforcement would result in "dire" tax consequences.[554] This advice was alleged to be incorrect.[555] Unfortunately, *Spencer* did not address the substance of the allegation, but focused only on statute of limitations issues. The court affirmed the trial court's award of summary judgment to the defendant on statute of limitations grounds.[556]

2. Method of Accounting

Adopting or utilizing an incorrect method of accounting could easily result in the imposition of malpractice liability.[557] Since this area involves choosing or applying proper tax accounting principles, the most likely defendant will be an accountant rather than an attorney. Two recent cases involved accountants faced with such malpractice claims, although in both the defendants avoided liability.[558]

In *Ideal Electronic Security Co. v. Brown*[559] the defendant accountant avoided liability on statute of limitations grounds. The defendant in that

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[550] *BDO Seidman, L.L.P.*, 745 So. 2d at 1082–83. The court quoted a letter from the client to the accountant, which indicated that the land was sold only because the plaintiff expected tax benefits. *Id.* at 1083.

[551] *Id.* at 1083.

[552] *Id.* at 1084–85.

[553] 91 Fed. Appx. 48 (10th Cir. 2004).

[554] *Id.* at 51.

[555] *Id.*

[556] *Id.* at 49.

[557] *See* Todres, *supra* note 1, at 626–27.

[558] *See* Ideal Elec. Sec. Co., v. Brown, 817 A.2d 806 (D.C. 2003); Hunter's Ambulance Serv. Inc. v. Shernow, 798 A.2d 991 (Conn. App. Ct. 2002).

[559] 817 A.2d 806 (D.C. 2003).

case rendered general accounting services, including the preparation of financial statements and tax returns, to the plaintiff corporation. In 1991, the plaintiff corporation split into two corporations, and the defendant continued to prepare tax returns for one of the successor corporations from 1991 through 1993. These returns incorrectly treated unbilled receivables.[560] Interestingly, the accountant for the other successor corporation similarly utilized the incorrect cash method rather than the accrual method, of accounting.[561] A number of years later, the IRS assessed large sums against the plaintiffs for their incorrect tax filings. Fortunately for defendant Brown, the court affirmed the jury's verdict, and held that the statute of limitations had expired when this suit was instituted. The plaintiffs simply sat on their rights too long.[562]

In *Hunter's Ambulance Service, Inc. v. Shernow,*[563] the defendant accountant avoided liability on much more fundamental grounds—there was inadequate evidence to establish his responsibility. The plaintiff corporation had purchased all the stock of another corporation in January 1989. Certain favorable treatment for the transaction would have been available if the transaction had occurred during 1988 and if, in addition, the plaintiff had filed a required notice with the IRS.[564] Notwithstanding the fact that the purchase occurred after 1988, the plaintiff's prior accountant reported the transaction as if it had qualified for the favorable 1988 treatment, and consistently continued such treatment on the plaintiff's 1989 and 1990 income tax returns.[565] Plaintiff terminated the employment of the prior accountant in the spring of 1991 and hired Shernow, the defendant, as his replacement. The IRS commenced an audit of plaintiff in 1992 that focused on this acquisition. At the end of the audit in 1994, the IRS issued a notice of deficiency against the plaintiff for over $200,000.[566] In the action against Shernow the plaintiff alleged that Shernow committed professional malpractice by not discovering the prior accountant's error and notifying the plaintiff thereof and by continuing to file subsequent tax returns as if the prior accountant properly reported the acquisition.[567] The evidence indicated, however, that although Shernow

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[560] *Id.* at 807–08. Though the opinion does not specify the nature of the error in any more detail, inferentially it would appear that unbilled receivables were not reported as income.

[561] *Id.* at 808.

[562] *Id.* at 810–11.

[563] 798 A.2d 991 (Conn. App. Ct. 2002); *see supra* Part II.A.2 (discussing other aspects of this case).

[564] 798 A.2d at 994.

[565] *Hunter's Ambulance Service*, 798 A.2d at 994.

[566] *Id.*

[567] *Id.* at 995.

had repeatedly asked for the prior accountant's work papers, which might have enabled him to ascertain the correct facts, these work papers were never received.[568] Accordingly, judgment was entered for the defendant, which was subsequently affirmed on appeal.[569]

3. Furnishing Incorrect Information Returns[570]

Our federal income tax system imposes the obligation to file various types of information returns on many different persons. For instance, employers must report annual wages paid and taxes withheld on form W-2,[571] payors of interest, dividends, royalties, and others must report such amounts on annual forms 1099,[572] and recipients of mortgage interest must report such amounts annually on form 1098.[573] Given the breadth and complexity of the reporting requirements, the possibility of error and resulting damages incurred would seem quite high.[574] A recently reported case illustrated such a situation, although it focused solely on statute of limitation issues.

In *Newhall* v. *Posner*[575] the plaintiff was a longtime employee, officer, director, and shareholder in an S corporation[576] that was sold. Upon the sale of the corporation the corporation's accountants prepared information returns reporting how much of the shareholders' gains were attributable to various states. An error was made on the California information return, which reported that $11.7 million of capital gains were 100% attributable to California. In fact, only about nineteen percent was attributable to California. As a result, substantial additional taxes, interest, and penalties were initially paid to California. Substantial costs were then incurred to correct the situation and recover the overpayments.[577] The plaintiff then sued the corporation's accountants for over $440,000 in damages.[578] While the facts of *Newhall* present an almost classic textbook

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[568] *Id.* at 997–98.

[569] *Id.* at 1001–02.

[570] *See generally* Todres, *supra* note 5, at 261–63.

[571] I.R.C. § 6041(a) (2000).

[572] *See*, I.R.C. §§ 6049, 6042.

[573] I.R.C. § 6050H.

[574] The discussion in the text assumes the error was not corrected by the issuance of an amended information form.

[575] No. 03-11279-PBS, 2004 U.S. Dist. LEXIS 3257 (D. Mass. Mar. 4, 2004).

[576] An S Corporation generally does not pay federal income tax like a regular C Corporation does. Instead, an S Corporation is a conduit which passes through its income and deductions to its shareholders who report such items on their tax returns. *See generally* I.R.C. §§ 1363, 1366–1368.

[577] *Newhall*, 2004 U.S. Dist. LEXIS 3257, at *3–6.

[578] *Id.* at *6.

case for a court to address the issues arising from, and damages recoverable in, such a situation, the case focuses exclusively on, and ultimately granted, the defendants' motion for summary judgment on statute of limitations grounds.[579]

4. Excessive Compensation

The United States employs a tax scheme known as double taxation.[580] A corporation is taxed on the income it earns.[581] When any remaining earnings are distributed by the corporation to the individual shareholders, the distributions are again subjected to tax as dividends.[582] Increasing the salaries paid to owners who are also employees of a closely held corporation is an effective self-help method to reduce or eliminate the double taxation. Since bona fide salaries paid by corporations are deductible,[583] one layer of the double tax is eliminated. As a consequence, the IRS is very vigilant to disallow deductions for "unreasonable and excessive compensation."[584] As a result, over the years many tax cases have arisen which address whether compensation is excessive under such circumstances.[585]

In *Curtis v. Kellogg & Andelson*,[586] plaintiff-corporation, of which Dr. Curtis was the sole shareholder, brought an action against its accountant, alleging that the defendant advised the corporation to pay the shareholder's wife compensation of over $431,000 in 1988 and over $510,000 in 1989. The IRS subsequently disallowed all compensation paid in excess of $100,000 and $105,000, respectively,[587] causing additional taxes of over

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[579] An interesting feature of the case that the court notes, but does not otherwise address, is that the defendant accountants were never retained by the plaintiff. *Id.* at *3–4. If ever there were a privity issue that begs for explication, this certainly is it.

[580] *See* BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 1.03 (7th ed. 2000).

[581] *See* I.R.C. § 11.

[582] *See* I.R.C. § 61(a)(7). When the shareholder is a corporation, a mechanism exists to eliminate or substantially reduce the tax at the shareholder level so that the double tax does not expand to become triple or quadruple taxation. *See* I.R.C. § 243 (allowing deductions for C corporations receiving dividends).

[583] *See* I.R.C. § 162(a)(1).

[584] Pepsi-Cola Bottling Co. of Salina, Inc. v. Commissioner, 528 F.2d 176, 178 (10th Cir. 1975).

[585] *See, e.g.*, Haffner's Serv. Stations, Inc. v. Commissioner, 326 F.3d 1, 2–5 (1st Cir. 2003) (finding bonuses not reasonable compensation after considering the employer's performance, comparable compensation and the employee's role in the company); Eberl's Claim Serv., Inc. v. Commissioner, 249 F.3d 994, 996 (10th Cir. 2001) (asserting excessive salary constituted disguised dividend payments); Exacto Spring Corp. v. Commissioner, 196 F.3d 833, 834 (7th Cir. 1999) (interpreting and applying I.R.C. § 162(a)(1) on appeal).

[586] 86 Cal. Rptr. 2d 536 (Cal. Ct. App. 1999).

[587] *Id.* at 538.

$300,000 to be incurred, in addition to legal fees for representation during the audit and subsequent Tax Court proceedings and also mental, physical, and emotional pain for which they sought to recover.[588] While the case had the potential to be groundbreaking on the issue of recoverable damages, that issue was dismissed on statute of limitations grounds.[589]

The plaintiffs in *Curtis* also attempted to recover from the attorneys who represented them during an audit and in Tax Court, based on the attorneys' failure to inform the plaintiffs of the existence of the accountant's negligence.[590] This claim was also dismissed on procedural grounds, specifically for lack of standing. The original owner of the claim was the corporate taxpayer. When the corporate taxpayer filed for bankruptcy, the bankruptcy trustee became the owner of the claim. Since the trustee in bankruptcy never pursued the claim, and because California law forbids assignment of legal malpractice claims, it was impossible to transfer the claim either to the owner of the corporation or to the post-bankruptcy corporation. The plaintiffs in this action, therefore, lacked standing to bring this claim.[591]

5. Benefit Plans

Because the tax rules relating to the benefits area are especially complex and arcane,[592] one would expect a substantial number of malpractice cases in this area. However, only three recent cases were discovered.[593] While all three raise the type of issue one would expect to encounter in this area, none of them addressed the substance.

In *Finderne Management Co. v. Barrett*, several small business entities were fraudulently prompted to establish a welfare benefit plan for their employees.[594] Prior to establishing the plan, and during its early years of operation, they were promised that contributions to the plan would be tax deductible. Later it was determined that the tax deduction was not available and this suit was brought against the insurance agents and financial planners for making the false representations.[595] The New Jersey

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[588] *Id.* at 538–39.

[589] *See id.* at 541–44.

[590] *Id.* at 539.

[591] *Id.* at 544–47.

[592] *See, e.g.*, I.R.C. §§ 401–409 (2000) (discussing qualified pension, profit-sharing, and stock bonus plans).

[593] DiMartino v. Somerset Fin. Servs., No. IP 03:cv-0672-JDT-WTL, 2003 U.S. Dist. LEXIS 24222 (S.D. Ind. 2003); Herrmann v. McMenomy & Severson, 590 N.W.2d 641 (Minn. 1999); Finderne Mgmt. Co. v. Barrett, 809 A.2d 857 (N.J. Super. Ct. App. Div. 2002).

[594] *Finderne Mgmt. Co.*, 809 A.2d at 859.

[595] *Id.* at 859–60.

Appellate Court affirmed a dismissal due to lack of privity between the defendant and the plaintiff's accountant, and also between two third-party defendants and the plaintiff's accountant.[596]

DiMartino v. Somerset Financial Services[597] likewise involved an accountant financial advisor who advised the plaintiff and her professional corporation to set up a benefit plan. Similarly, the promised tax benefits later turned out to be unavailable.[598] The opinion, however, addressed only a jurisdictional issue, concluding that state jurisdiction was appropriate.[599]

Under the rules governing benefit plans, a substantial excise tax and interest is imposed on a disqualified person who engages in a prohibited transaction with a related benefit plan.[600] In *Herrmann v. McMenomy & Severson*,[601] the plaintiff employer brought a suit against his attorney[602] alleging that the attorney negligently failed to advise the plaintiff that certain transactions it entered into with its employee benefit plan violated this prohibition and would be subject to the excise tax. Unfortunately, the case focused solely on the statute of limitations, ultimately holding that under Minnesota law, the case was time-barred.[603]

6. Section 1031—Like-Kind Exchanges

Section 1031 of the I.R.C. is a useful provision because it enables taxpayers to make an exchange for "like-kind" property without immediately recognizing taxable gain.[604] In *Montes v. Asher & Co.*,[605] the plaintiffs owned a McDonald's restaurant which they sold back to the company. In connection with the transaction they sought accounting assistance and advice from the defendant accountant. Part of their discussions with the accountant included the possibility of purchasing another restaurant. The accountant never discussed the availability of a § 1031 like-kind exchange with the plaintiffs although, she later

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[596] *Id.* at 859. In a related case, *Finderne Mgmt. Co. v. Barrett*, 809 A.2d 842 (N.J. Super. Ct. App. Div. 2002), the same New Jersey Appellate Court held the present suit against the defendants was not preempted under the federal ERISA preemption provision, 29 U.S.C. § 1144(a) (2000). *Id.* at 843.

[597] No. IP 03:cv-0672-JDT-WTL, 2003 U.S. Dist. LEXIS 24222 (S.D. Ind. 2003).

[598] *Id.* at *7–8.

[599] *Id.* at *44–45.

[600] *See generally* I.R.C. § 4975 (2000).

[601] 590 N.W.2d 641 (Minn. 1999).

[602] The suit was also brought against plaintiff's accountants, but they were not part of this appeal. *Id.* at 642 n.1.

[603] *Id.* at 642–44.

[604] I.R.C. § 1031(a) (2000).

[605] 182 F. Supp. 2d 637 (N.D. Ohio 2002).

acknowledged, it "might have eliminated some of the taxable gain from the sale of their restaurant."[606]

The court granted the plaintiff's motion for summary judgment on the issue of liability, holding that failing to discuss the like-kind exchange option was a clear breach of the standard of care owed by an accountant to a client, and a reasonable jury could not find otherwise.[607] The case was sent back for trial on the issues of damages.[608]

7. Section 1033—Involuntary Conversions

Under I.R.C. § 1033 when a taxpayer's property is involuntarily converted, at the election of the taxpayer, any resulting gain need not be reported for federal income tax purposes if the taxpayer purchases suitable replacement property within a designated time.[609] The entire gain may go unrecognized only if the taxpayer spends on the replacement property an amount at least equal to the proceeds received from the disposition of the old property. If the taxpayer spends less on the replacement property than was received from the old property, gain is recognized equal to the excess of the non-reinvested proceeds.[610]

Due to the operation of § 1033's basis rules, the unrecognized gain does not permanently escape taxation, but is simply deferred until such time as the replacement property is disposed of.[611]

In *J.D. Warehouse v. Lutz & Co.*,[612] a partnership, under threat of condemnation, sold a warehouse for $3.15 million in May of 1988, resulting in a realized gain of over $2.44 million. In 1989, the partners consulted with the defendant accountant concerning the requirements for gain deferral under I.R.C. § 1033. The accountant erroneously advised

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[606] *Id.* at 637.

[607] *Id.*

[608] *Id.* at 638.

[609] *See* I.R.C. § 1033(a)(2). An involuntary conversion would include property destruction, theft, or forced sale under condemnation or the threat or imminence thereof. *Id.* § 1033(a). A gain may arise under such involuntary circumstances if the amount received from insurance proceeds or from the purchaser in a forced sale exceeds the taxpayer's adjusted basis in the property.

[610] *Id.* § 1033(a)(2)(A).

[611] Under I.R.C. § 1033(b)(2), the basis of the replacement property is its cost less the unrecognized gain on the involuntarily converted property. This preserves the unrecognized gain for later recognition. To illustrate, assume a taxpayer has property worth $1 million in which the basis is $100,000. Upon destruction of the property, assume insurance proceeds of $1 million are received. If section 1033 treatment is elected, the $900,000 gain is not recognized. However, if replacement property costing $2 million is purchased by the taxpayer, its tax basis will be only $1.1 million (i.e., its cost ($2 million) less the unrecognized gain ($900,000)). The previously unrecognized gain of $900,000 is now preserved in the replacement property that is worth $2 million but has a tax basis of only $1.1 million.

[612] 639 N.W.2d 88 (Neb. 2002).

them that the entire gain could be deferred if they purchased suitable replacement property for an amount equal to the $2.44 million gain on the sale. Relying on this advice they timely purchased suitable replacement property costing $2.5 million. The error was caught in 1992 by the IRS during an audit of the 1988 tax return, resulting in additional tax and interest, but no penalties, imposed on over $520,000 of capital gains.[613] The partnership and the individual partners filed suit against the accountant and his firm, claiming malpractice. The plaintiffs sought to recover the additional federal and state taxes and interest; attorney and accountant fees incurred; the estimated value of an investment tax credit lost by one of the partners;[614] and the estimated loss of time and income by two of the partners in dealing with the problem.[615]

The trial court had no difficulty in finding the defendants liable. The court found the error by the accountant clearly fell below the standard of care applicable to accountants in the area and that the plaintiffs had relied on the accountant's advice. The only remaining issue requiring analysis was determination of damages.[616]

One of the trial court's most significant holdings was its rejection of the defendants' argument that valuation of the "loss of a right to defer income necessarily requires speculation and conjecture, as a matter of law, and . . . cannot therefore serve as the basis for a damage award."[617] The trial court further found "the value of the loss of the tax deferral may constitute recoverable damage if it can be established with a reasonable degree of certitude."[618] Nevertheless, the court did not award damages of this type.

The trial court's holding with respect to the recovery of additional taxes is also noteworthy. The trial court essentially held that the defendant's advice was not the legal "cause" of these damages. The trial court reasoned that the plaintiffs incurred the tax liability in May of 1988 when they sold the warehouse. Since utilization of § 1033 merely defers, but does not eliminate the tax liability, the court concluded that the accountant's erroneous advice given in 1989 did not create the plaintiff's tax liability. Therefore, because the defendants were not the "legal cause" of the additional taxes, no damages were recoverable.[619] The trial court's opinion, failed to consider the critical point that the accountant was

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[613] *Id.* at 90–91.

[614] The court never explained the nature of this loss.

[615] *J.D. Warehouse*, 639 N.W.2d at 91.

[616] *Id.* at 91.

[617] *Id.*

[618] *Id.*

[619] *Id.* at 91–92.

specifically retained to obtain § 1033 treatment and that, but for his negligence, no tax would have been owed for 1988. This brings the analysis back to determining the value of the ability to defer taxes, which the trial court had just endorsed in principle but did not apply.

The trial court also held that the interest[620] imposed on the plaintiffs by the IRS was not recoverable.[621] Because the plaintiffs had the use of the money, the court simply held paying the IRS simple interest was not really damages suffered by the plaintiffs, and not recoverable.[622] Interestingly, the court did not even bother to acknowledge the existing split amongst the states on this issue.[623]

With respect to the other elements of damages sought by the plaintiffs, the trial court: (a) while not rejecting outright the claims of the two partners for lost time and income, did not award any damages on these claims; (b) held the partner's claimed loss of an investment tax credit was not recoverable since it was to be treated as part of the claim for additional taxes; and (c) did award damages equal to the attorney fees of $10,000 incurred in connection with the audit.[624]

On appeal, the Nebraska Supreme Court considered the issue to be whether the capital gains tax, interest and the value of the partner's lost investment tax credit were recoverable damages.[625] The court reiterated some basic and noncontroversial principles, for instance, noting that the purpose of damages is to place the injured party in the same position, as far as money can do, as the party would have been in had there been no injury. The Nebraska Supreme Court also pointed out that while damages need not be established by the plaintiff with mathematical certainty, damages cannot be established by speculative or conjectural evidence.[626] However, the court sidestepped addressing the substantive issues before it, instead holding that there was insufficient evidence before the trial court to establish the amount of any damages other than $10,000 in attorney fees.[627] The problem was that the case was tried based on stipulated facts. While the stipulation indicated that additional capital gain of over $520,000 was found by the IRS, and that additional taxes and interest were actually paid

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[620] The IRS did not impose any penalties on the plaintiffs so the recovery of penalties was not in issue. *Id.* at 92.

[621] *Id.*

[622] *Id.*

[623] For a discussion of the split among the courts, see *supra* text accompanying notes 274–85. *See generally* Rule, *supra* note 276, at 176.

[624] *J.D. Warehouse*, 639 N.W.2d at 91–92.

[625] *Id.* at 92.

[626] *Id.* at 92–93.

[627] *Id.* at 93–94.

by each partner,[628] the amounts of such payments were never indicated in the stipulation.[629]

Alas! What could have been a groundbreaking opinion in the area of damages in a tax-deferral situation was not to be!

CONCLUSION

It is not possible to simply tally up either the number of cases discussed herein or the number of cases cited and present a list of the areas most frequently litigated. A number of cases reviewed never found their way into this article. While I would like to think I applied definitive standards consistently to decide what was included and what was excluded, unfortunately, those decisions were much more judgmental. An extra sentence or two describing the underlying tax malpractice in a bit more detail might easily have swayed me to include a case that otherwise addresses a statute of limitations issue not relevant to this article. In addition, many cases involved allegations of several different acts of malpractice, some of which were obviously make-weight and not really deserving of attention. Accordingly, the conclusions herein involve a good measure of value judgment rather than a precise tally of cases.

In the years since *Malpractice I*, the specific area that seems to have generated the most cases is the estate planning/estate and gift tax area.[630] There seems to be a steady stream of cases involving either planning or drafting errors.[631] Similarly, the failure to advise a client of the existence and/or benefit of the qualified disclaimer has been a recurring issue.[632] This finding is consistent with *Malpractice I* in which this area was one of the two leading areas in generating tax malpractice claims. The second leading area in *Malpractice I*, cases relating to tax shelters, has quieted down, as predicted in *Malpractice I*,[633] presumably due to the crackdown

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[628] In partnership taxation, the partnership is a pass-through entity that files a tax return but does not pay tax. Tax is paid by each partner on his/her ratable share of partnership income and deductions. *See* I.R.C. § 701 (2000).

[629] *J.D. Warehouse*, 639 N.W.2d at 93–94.

[630] Conceptually, the generation skipping transfer tax ("GST tax") should also be included together with the estate and gift tax—it is the third member of the trio of taxes that presently comprises the IRC's transfer taxes—however, as indicated previously, see *supra* note 17, no cases involving the GST tax have been encountered. In light of the complexity of the GST tax it is most likely that such cases will soon reach the reporters. *See* Priv. Ltr. Rul. 97-36-032 (June 9, 1997).

[631] *See supra* Part II D.2.a–b. *See generally* Begleiter, *supra* note 17, at 347–50 (discussing malpractice cases in the estate planning area).

[632] *See supra* Part II D.2.c.

[633] *See* Todres, *supra* note 1, at 641.

on tax shelters that culminated with the Tax Reform Act of 1986.[634] A resurgence of such cases may arise in future years, as the extent and ferocity of the IRS's attack on the shelters of the mid-1990s becomes more defined and as taxpayers seek to recover some of their unrealized tax benefits from the tax advisors who recommended the faulty shelters.

The next largest area, after the estate planning/estate and gift tax area, is probably a combination of the late filing/non-filing and negligent preparation areas discussed in Parts II.B.2–3 above. These areas, though, do not involve one area of the tax law but rather represent a more general type of sloppiness or inattentiveness. Beyond these, there seem to be at most two to three cases that may have arisen in any one area, each with its own unique wrinkle or twist.

As was true in *Malpractice I*, it is this author's view that, upon reflection, the estate planning/estate and gift tax area is a most logical candidate for the top spot in tax malpractice areas. It involves a network of interrelated areas, many with highly technical and intricate requirements in which the opportunity for error is ever present. For instance, charitable and marital deductions,[635] the Q-TIP election,[636] and sections 2035 to 2038[637] and 2041[638] are as technical and strewn with minefields as any other provisions of the Internal Revenue Code. In addition to the complexity, this is an area in which there is often no personal relationship between the plaintiff and the defendant. While the decedent may have had such a relationship with the defendant, the heirs typically have not. When an heir feels entitled to more than he or she has received, there is no restraining influence of any personal relationship or the memory of other successful representations. It is very easy to simply sue the draftsman of the will or the tax advisor, especially when they may appear to have deep pockets.

Concerning the correct measure of damages, the most telling observation is that most of the cases discussed herein do not focus on the measure of damages. With respect to all areas of tax malpractice other than estate planning/estate and gift tax, the tax professionals frequently

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[634] *See* Pub. L. No. 99-514, 100 Stat. 2085.

[635] I.R.C. §§ 2055, 2056 (2000); *see, e.g.*, Rutter v. Jones, Blechman, Woltz & Kelly, P.C., 568 S.E.2d 693 (Va. 2002), discussed *supra* Part II.D.2.b (charitable deduction).

[636] I.R.C. § 2056(b)(7); *see, e.g.*, Boardman v. Stark, No. 20911, 2002 Ohio App. LEXIS 3790 (Ohio Ct. App. July 24, 2002), discussed *supra* Part II.D.2.a.

[637] I.R.C. § 2035–38.; *see, e.g.*, Harmeyer v. Gustafson, No. C8-00-1191, 2001 Minn. App. LEXIS 175 (Minn. Ct. App. Feb. 5, 2001), discussed *supra* Part II.D.2.b.

[638] I.R.C. § 2041; *see, e.g.*, Porter v. Ogden, Newell & Welch, 241 F.3d 1334 (11th Cir. 2001), discussed *supra* Part II.D.2.b.

escaped liability by reason of the statute of limitations.[639] In the estate planning/estate and gift tax area there are a number of additional procedural obstacles that often prevent the imposition of damages. Among these additional obstacles are issues of privity, sometimes presented as lack of standing,[640] the fact that in certain jurisdictions tax malpractice actions do not survive the death of the wronged party[641] and the principle that speculative damages are not recoverable.[642]

While the unique set of procedural issues in the estate planning/estate and gift tax area suggest this area ideally should be analyzed separately from other tax malpractice areas,[643] from a pragmatic standpoint, the areas have been combined herein since the basic types of recoverable damages seem to be roughly the same across all areas of tax malpractice. The basic elements of damages include any additional taxes caused by the malpractice, as well as interest and penalties and all corrective or mitigating costs incurred, such as attorney or accountant fees for filing late or amended returns, for representation before the IRS, or for litigation to minimize or eliminate the damages caused by the malpractice.[644] With respect to additional taxes, the amount recoverable would include only taxes that could have been avoided with non-negligent advice.[645] However, if taxes were already incurred, but errors mislead the taxpayer to believe that less is owed, the additional taxes will not be recoverable since they were not really caused by the malpractice.[646] To illustrate, if a taxpayer owes $100,000 in taxes, but the return preparer errs and advises the taxpayer that only $80,000 is owed, the additional $20,000 would not

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[639] *See, e.g.*, Tony Smith Trucking v. Woods & Woods, Ltd., 55 S.W.3d 327 (Ark. Ct. App. 2001); Avakian v. Ohanessian, No. B150367, 2002 Cal. App. Unpub. LEXIS 9275 (Cal. Ct. App. Oct. 3, 2002); Noel v. Hoover, 12 P.3d 328 (Colo. Ct. App. 2000); Inphoto Surveillance Inc. v. Crowe, Chizek & Co., 788 N.E.2d 216 (Ill. App. Ct. 2003); Wiste v. Neff & Co., 967 P.2d 1172 (N.M. Ct. App. 1998), discussed *supra* Part II.B–D.

[640] *See, e.g.*, Borissoff v. Taylor & Faust, 117 Cal. Rptr. 2d 138 (Ct. App. 2002), *rev'd*, 93 P.3d 337 (Cal. 2004) (standing); Blair v. Ing, 21 P.3d 452 (Haw. 2001) (privity), discussed *supra* Part II.B.2, D.2.b.

[641] *See, e.g.*, Rutter v. Jones, Blechman, Woltz & Kelly, P.C., 568 S.E.2d 963 (Va. 2002), discussed *supra* Part II.D.2.b.

[642] *See, e.g.*, *Harmeyer*, 2001 Minn. App. LEXIS 175, discussed *supra* Part II.D.2.b (same).

[643] *See, e.g.*, Begleiter, *supra* note 17; *see also* Bradley E.S. Fogel, *Estate Planning Malpractice: Special Issues in Need of Special Care*, PROB. & PROP., July/Aug. 2003, at 20.

[644] *See, e.g.*, Pytka v. Gadsby Hannah L.L.P., No. 01-1546 BLS, 2002 Mass. Super. LEXIS 461, at *25 (Mass. Super. Ct. Nov. 12, 2002); Hosfelt v. Miller, No. 97-JE-50, 2000 Ohio App. LEXIS 5506, at *15–16 (Ohio Ct. App. Nov. 22, 2000); King v. Neal, 19 P.3d 899, 901 (Okla. Civ. App. 2001), discussed *supra* Parts II.B.3, II.D.1.b, II.D.2.c.

[645] *See, e.g.*, *Pytka*, 2002 Mass. Super LEXIS 461 (Mass. Super. Ct. Nov. 12, 2002); *King*, 19 P.3d 899, discussed *supra* Part II.B.3, II.D.1.b.

[646] *See, e.g.*, J.D. Warehouse v. Lutz & Co., 639 N.W.2d 88, 92 (Neb. 2002), discussed *supra* Part II.E.7.

be recoverable from the return preparer since his or her error did not cause the additional taxes to be incurred. The contrary holds true with regards to any interest or penalties that resulted from the underreporting of the taxes owed.

There continues to be a split among the states with respect to the recovery of interest charged in connection with a tax underpayment. Some states allow the recovery of interest as simply being a natural, consequential component of damages incurred by a wronged plaintiff.[647] Other states refuse to allow any recovery for interest on the ground that it would be duplicative of the benefit already enjoyed by the plaintiff, that of having had the use of the money.[648] A third view has recently emerged that only allows a recovery of the differential between the interest paid to the government and the interest actually earned on the money while the plaintiff possessed it.[649]

Punitive or exemplary damages may be recoverable under appropriate circumstances,[650] while no recovery is generally available for emotional distress or mental anguish.[651] Under the so-called American Rule, most states do not allow recovery of attorney's fees incurred to litigate the malpractice action.[652] These non-recoverable attorney's fees must be distinguished from recoverable attorney's fees incurred to correct or mitigate damages caused by the malpractice. Thus, for instance, attorney's fees are recoverable for the cost of litigation necessary to avoid paying penalties imposed by the IRS on account of the tax malpractice.[653]

While these basic general principles seem reasonably well established, many issues remain open. For instance, the general rule that only foreseeable consequential damages may be recovered has been held to prevent any recovery for suicide committed by a taxpayer who may have been misadvised as to a tax matter.[654] However, it is interesting to speculate whether the costs incurred by the plaintiff in *Porter v. Ogden,*

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[647] *See, e.g.*, McCulloch v. Price Waterhouse L.L.P., 971 P.2d 414, 417–20 (Or. Ct. App. 1998); discussed *supra* Part II.B.3; *see also* Streber v. Hunter, 221 F.3d 701, 734 n.47 (5th Cir. 2000); Ronson v. Talesnick, 33 F. Supp. 2d 347, 354 (D.N.J. 1999), discussed *supra* Part II.D.1.a.

[648] *See, e.g.*, *J.D. Warehouse*, 639 N.W.2d at 93–94, discussed *supra* Part II.E.7.

[649] *See, e.g.*, *Streber*, 221 F.3d at 734–35, discussed *supra* Part II.D.1.a.

[650] *See, e.g.*, *King*, 19 P.3d at 900, discussed *supra* Part II.B.3. In *King*, the jury considered, but did not award, punitive damages. *King*, 19 P.3d at 900; *see also* Todres, *supra* note 1, at 644.

[651] *See, e.g.*, *McCulloch*, 971 P.2d at 421, discussed *supra* Part II.B.3.

[652] *See* Todres, *supra* note 1, at 644.

[653] *See e.g.*, *Streber*, 221 F.3d at 716–17, discussed *supra* Part II.D.1.a.

[654] *See* Cleveland v. Rotman, 297 F.3d 569, 572–73 (7th Cir. 2002), discussed *supra* Part II.B.3.

Newell & Welch[655] to lobby the Florida legislature to change Florida law to solve his tax problem would be recoverable consequential damages. Similarly, the issue of grossing-up damages so the amount recovered on an after-tax basis is equal to the damages incurred seems to be conceptually appealing, despite its rejection by *Pytka v. Gadsby Hannah, L.L.P.*[656] Finally, many desirable Internal Revenue Code provisions involve tax deferral rather than total tax avoidance.[657] While the trial court in *J.D. Warehouse v. Lutz & Co.*[658] held that loss of the opportunity to defer taxes may constitute recoverable damages, it nevertheless did not award any. The Nebraska Supreme Court sidestepped the issue on appeal, based on the absence of adequate evidence.[659] How damages would be determined in such circumstances is most interesting.[660] Perhaps there will be a reported decision on remand in *Montes v. Asher & Co.*,[661] which is to address this issue.

In short, many intriguing issues remain unanswered concerning the question of precisely what damages are recoverable in tax malpractice actions.

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[655] 241 F.3d 1134 (11th Cir. 2001); *see supra*, Part II.D.2.b.

[656] No. 01-1546 BLS, 2002 Mass. Super. LEXIS 461 (Mass. Super. Ct. Nov. 12, 2002); *see supra* Part II.D.1.b.

[657] *See, e.g.*, I.R.C. §§ 1031, 1033 (2000), discussed *supra*, Part II.E.6–7.

[658] 639 N.W.2d 88 (Neb. 2002); *see supra*, Part II.E.7.

[659] *J.D. Warehouse*, 639 N.W.2d at 93; *see supra* Part II.E.7.

[660] One commentator has expressed the view that damages ought not be recoverable in such circumstances. *See* Jeffrey A. Rich, *Financial Professionals' Liability To Clients for Lost Tax Benefits*, 80 TAX NOTES 217 (1998).

[661] 182 F. Supp. 2d 637 (N.D. Ohio 2002); *see supra* Part II.E.6.