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### Bad Tax Shelters - Accountability of the Lack Thereof: Ten Years of Tax

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*St. John's University School of Law*

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BAD TAX SHELTERS — ACCOUNTABILITY OR THE LACK THEREOF:  
TEN YEARS OF TAX MALPRACTICE

Jacob L. Todres\*

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Despite the existence of state rules governing attorney conduct, state bar ethics committees, similar conduct guides for CPAs and the IRS office of Professional Responsibility, the ultimate deterrence to negligence by a tax professional is the threat of a lawsuit for damages caused by substandard conduct. This lawsuit also represents the only means by which a client may obtain redress for the damages caused by the negligence. The principles governing malpractice therefore function in a regulatory capacity to assure that professionals act with diligence and appropriate due care. If the professional does not meet the required standards, she or he must bear the consequences and compensate the client for the damages caused by the substandard conduct.

Tax is a very complex and technical area of law. Previously, as a practitioner, and now, as a long-time teacher in the area, I was always concerned whether the incidence of malpractice liability exposure was especially high in this area of legal practice. And, if yes, whether it was possible to identify which areas of tax law were most prone to generate tax malpractice claims. In two earlier studies, I allayed my worst fears that tax was so dangerous an area to practice in that it would be foolhardy to do so.<sup>1</sup> No, there were not reported tax malpractice claims under virtually every

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<sup>1</sup>Jacob L. Todres, *Malpractice and the Tax Practitioner: An Analysis of the Areas in Which Malpractice Occurs*, 48 EMORY L.J. 547 (1999) [hereinafter *Malpractice I*]; Jacob L. Todres, *Tax Malpractice: Areas in Which It Occurs and the Measure of Damages—An Update*, 78 ST. JOHN'S L. REV. 1011 (2004) [hereinafter *Malpractice II*].

section of the Internal Revenue Code (“IRC”). In *Malpractice II*, which was published in 2004, I concluded that the estate planning/estate and gift tax area probably generated the most tax malpractice claims during the previous half-decade.<sup>2</sup> Beyond that, the areas generating the most claims involved late filing, non-filing, and negligent tax return preparation.<sup>3</sup> The errors in these areas, though, were not so much errors of tax law, but rather were general sloppiness and inattentiveness that occurred in a tax context — such as missing time deadlines and not following instructions.<sup>4</sup>

By the mid to late 1990s and probably continuing until around 2004 or 2005, the tax landscape had become overrun with tax shelter promoters aggressively marketing tax shelters to very wealthy individuals.<sup>5</sup> The shelters were very aggressive and highly technical structured transactions that purportedly could eliminate millions, tens, and even hundreds of millions of dollars of taxes on demand. These shelters were mass marketed to many taxpayers. The shelters, which, at best, were of doubtful validity, were really of the too-good-to-be-true variety. Probably starting in the late 1990s, and certainly by the early 2000s, the Internal Revenue Service (“IRS”) was actively and vigorously cracking down on the investors and purveyors of these flawed tax shelters.<sup>6</sup> Ultimately, many of the purchasers of these tax shelters conceded the invalidity of the shelters and availed themselves of IRS amnesty and settlement initiatives.<sup>7</sup> As a result, there were numerous predictions that a wave of malpractice suits against the tax

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<sup>2</sup> *Malpractice II*, *supra* note 1, at 1089.

<sup>3</sup> *Id.* at 1090.

<sup>4</sup> *Id.*

<sup>5</sup> For excellent overviews of tax shelters *see, e.g.*, Eric Solomon, *A Short History of Tax Shelters*, in 1 *The Partnership Tax Practice Series: Planning for Domestic and Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances* chap. 238, (Louis S. Freeman ed., 2014); and Donald L. Korb, *Shelters, Schemes, and Abusive Transactions: Why Today’s Thoughtful U.S. Tax Advisors Should Tell Their Clients to “Just Say No”*, in *The Corporate Tax Practice Series* chap. 442 (Philip B. Wright et al. eds., 2014).

<sup>6</sup> *See, e.g.*, Kenneth A. Gary, *Year In Review: Tax Shelter Crackdown Efforts Steer Government Policy*, 102 *TAX NOTES* 35, 35 (2004); *see also, generally* I.R.S. News Release IR-2003-51 (Apr. 15, 2003).

<sup>7</sup> 2,000 taxpayers were reported to have participated in one IRS global settlement initiative. Stephen Joyce, *About 2,000 Taxpayers to Pay \$2 billion in Global Settlement Initiative, Everson Says*, 59 *DAILY TAX REP.* (Mar. 28, 2006). In response to a different program for “Son of BOSS” tax shelters over 1,200 taxpayers participated. I.R.S. News Release IR-2004-87 (July 1, 2004) (over 1500 taxpayers filed Notices of Election to participate); I.R.S. News Release IR-2005-72 (July 11, 2005) (Over 1200 electing taxpayers qualified to participate in the settlement).

advisors involved with the invalid shelters would result.<sup>8</sup> After all, the shelters, which were very expensive, were invalid and worse than worthless. In addition to unwelcome and unwanted IRS scrutiny, the shelter investors incurred significant costs as a consequence of their shelter investments. These included interest expense, often penalties, and professional fees to correct erroneous tax returns and for representation in connection with IRS (and state) audits and claims. In addition, the basic tax the shelter purchasers were seeking to avoid also had to be paid.

The purpose of this article is to review the developments in the tax malpractice area during roughly the last decade. The goal is to determine how the substantive law in this area has evolved, what damages may be recovered when malpractice has occurred, and whether it is possible to identify particular areas of tax law or practice that are more likely than others to result in tax malpractice claims. Initially it was expected and hoped that the predicted wave of tax malpractice litigation against the sellers of the bad tax shelters during this period would be a fertile source of substantive developments in this area. Paradoxically, this has not occurred. While there are many cases arising from the bad tax shelters, to date very few have focused on substantive tax malpractice issues and only one, decided in late 2013, has gone to judgment on the merits.<sup>9</sup> Most of the reported cases have focused on procedural issues such as whether the disputes must be arbitrated,<sup>10</sup> statute of limitations,<sup>11</sup> jurisdiction in federal

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<sup>8</sup> See, e.g., Allen Kenney & Lee A. Sheppard, *Korb Predicts Shelter Malpractice Suits*, 2005 TAX NOTES TODAY 216–2 (Nov. 9, 2005); David Cay Johnston, *Wealthy Sue Accountants Over Shelters*, N.Y. TIMES, Feb. 7, 2003 at C1. See generally Jay A. Soled, *Tax Shelter Malpractice Cases and Their Implications for Tax Compliance*, 58 AM. U. L. REV. 267 (2008).

<sup>9</sup> Soled, *supra* note 8, at 274–75 (reporting that “there is not a single reported decision determining whether a particular defendant committed malpractice.”). The one reported case that reached judgment on the substantive tax malpractice issue is *Yung v. Grant Thornton LLP*, No. 07-CI-2647 (Ky. Cir. Ct. Nov. 8, 2013) available at <http://www.woodllp.com/Publications/Articles/pdf/Yung.pdf>.

<sup>10</sup> See, e.g., *Arthur Andersen LLP v. Carlisle*, 556 U.S. 624, 625 (2009); *Chew, Jr. v. KPMG, LLP*, 407 F. Supp. 2d 790, 792–93 (S.D. Miss. 2006); *Stechler v. Sidley, Austin Brown & Wood, L.L.P.*, 382 F. Supp. 2d 580, 583 (S.D.N.Y. 2005); *Alfano v. BDO Seidman, LLP*, 925 A.2d 22, 24 (N.J. Super. Ct. App. Div. 2007); *Conwill v. Arthur Andersen LLP*, 820 N.Y.S. 2d 842, \*1 (N.Y. Sup. Ct. 2006).

<sup>11</sup> See, e.g., *Malone v. Ahrens & DeAngeli, PLLC.*, 445 Fed. App’x 940, 943 (9th Cir. 2011); *Soward v. Deutsche Bank AG*, 814 F. Supp. 2d 272, 275 (S.D.N.Y. 2011); *Moorehead v. Deutsche Bank AG*, No. 11 C 106, 2011 WL 4496221, \*3 (N.D. Ill. Sept. 26, 2011); *Corporex Cos. v. Proskauer Rose, LLP*, 713 F. Supp. 2d 678, 681 (E.D. Ky. 2010); *Hutton v. Deutsche Bank AG*, 541 F. Supp. 2d 1166, 1173 (D. Kan. 2008).

versus state court,<sup>12</sup> and various other non-substantive tax malpractice issues.<sup>13</sup> In addition, since many of the tax shelters were mass marketed to many purchasers, several class action suits resolved what otherwise could have resulted in many hundreds of individual cases.<sup>14</sup> These class action cases were all settled, so they do not add much to substantive tax malpractice law, aside from confirming that normal class action principles apply, and a class action suit may be maintained where the same defective tax shelter is sold to many purchasers in the same way.<sup>15</sup> Presumably, many of the invalid tax shelter controversies were also resolved by arbitration, settlement, or in non-reported litigations.

Despite the dearth of tax shelter cases focusing on substantive tax malpractice issues, it is safe to conclude that tax professionals who render incorrect opinions that an invalid tax shelter is likely valid will most assuredly be the target of a tax malpractice suit brought by the disappointed purchaser of the tax shelter. When the tax professional's involvement with the marketing and sale of the tax shelter is as extensive as occurred in many of the "generic tax shelters," investigated by Congress, liability seems reasonably certain.<sup>16</sup> Where the tax professional's involvement is limited to

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<sup>12</sup> See, e.g., *Affco Invs., LLC v. KPMG, LLP*, Civ. A. No. H-07-3379, 2009 WL 3248052, \*2 (S.D. Tex. Sept. 28, 2009); *The Hoehn Family, LLC v. Pricewaterhousecoopers, LLP*, No. 07-0069-CV-W-DW, 2007 WL 1028768, \*1 (W.D. Mo. Mar. 30, 2007); *King v. Lincoln Fin. Advisors Corp.*, Civ. A. No. 3:05-CV-1626-G ECF, 2006 WL 2067835, \*1 (N.D. Tex. July 25, 2006) (mem. op., not designated for publication).

<sup>13</sup> See, e.g., *Conwill, IV v. Greenberg Traurig, L.L.P.*, Civ. A. No. 09-4365, 2009 WL 5178310, \*1 (E.D. La. Dec. 22, 2009) (personal jurisdiction); *Olson v. Jenkins & Gilchrist*, 461 F. Supp. 2d 710, 714 (N.D. Ill. 2006) (personal jurisdiction and arbitration); *RA Invs. I, LLC v. Deutsche Bank AG*, No. Civ. A. 3:04-CV-1565-G, 2005 WL 1356446, \*4 (N.D. Tex. June 6, 2005) (RICO) (mem. op., not designated for publication); *Ling v. Deutsche Bank AG*, No. 04 CV 4566(HB), 2005 WL 1244689, \*2 (S.D.N.Y. May 26, 2005); *Malone v. Nuber*, No. C07-2046RSL, 2009 WL 1044586, \*1-6 (W.D. Wash. April 16, 2009) (miscellaneous); *Shalam v. KPMG LLP*, 843 N.Y.S.2d 17, 18 (N.Y. App. Div. 2007) (miscellaneous).

<sup>14</sup> See, e.g., *Simon v. KPMG LLP*, Civ. A. No. 05-CV-3189, 2006 WL 1541048, at \*5 (D.N.J. June 2, 2006) (250 class members); *Ling v. Cantley & Sedacca, L.L.P.*, No. 04 Civ. 4566(HB), 2006 WL 290477, at \*1 (S.D.N.Y. Feb. 8, 2006) (complaint alleges 175 transactions, Complaint, 2004 WL 1735243 at ¶ 49 (6/16/04)); *Denney v. Jenkins & Gilchrist*, 230 F.R.D. 317, 330 (S.D.N.Y. 2005) (1100 clients).

<sup>15</sup> See, e.g., *Simon*, 2006 WL 1541048 at \*5; *Ling*, 2006 WL 290477, at \*1; *Denney*, 230 F.R.D. at 330.

<sup>16</sup> The term "generic tax shelters" follows terminology in two reports on the invalid tax shelters that were widely sold during the decade starting roughly around the mid-1990s that are focused upon herein. In describing the abusive tax shelters under investigation, both reports used very similar language and referred to generic tax products or generic tax shelters. These shelters

rendering an opinion on a transaction with which he or she has no personal interest, the likelihood of liability is probably lower.

Apart from the tax shelter situations, a number of cases have arisen during this past decade in the benefit plan area. Although treated separately from the tax shelter area, a number of these cases could reasonably be considered part of the same general tax shelter phenomenon as the generic tax shelters. Here too, many overly aggressive benefit plans were sold as valid, though they went beyond the limits of what was permissible. However, since these cases involved violations of specific statutory sections, they are treated separately from the generic tax shelters.

Besides the generic tax shelters and the benefit plan areas, no single area stands out prominently as being especially likely to generate tax malpractice claims. As was the situation previously, a number of cases arose in the scope of engagement area (*i.e.*, what exactly did the tax professional undertake), non-filing and late filing, and the estate and gift areas.

This study focuses solely on reported cases. It examines instances of claimed malpractice involving federal income, estate and gift taxation. No situations involving federal generation skipping taxes were discovered. While other taxes were not intended to be focused on, a number of the cases discussed involve federal payroll taxes and state and local taxes. While I believe I have located most of the significant cases, I do not delude myself into believing I discovered all the cases. I have intentionally omitted many of the tax shelter cases that do not focus on the substantive tax malpractice

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were described as complex transactions used to obtain tax benefits in a manner never intended. The transactions have neither economic substance nor any business purpose other than tax savings. These shelters, rather than being custom-designed for a single user were “prepared as a generic ‘tax product’ available for sale to multiple clients.” Minority Staff of the Perm. Subcomm. On Investigations of the Comm. On Governmental Affairs U.S. Senate, U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals: Four KPMG Case Studies: FLIP, OPIS, BLIPS and SC2, S. Rep. No. 108–34, at 2 (2003); Perm. Subcomm. On Investigations of the Comm. On Homeland Security and Governmental Affairs U.S. Senate: The Role of Professional Firms In The U.S. Tax Shelter Industry, S. Rep. No. 109–54, at 1 (2005).

These shelters have also been referred to as “technical” tax shelters. Del Wright Jr., *Financial Alchemy: How Tax Shelter Promoters Use Financial Products to Bedevil The IRS (And How The IRS Helps Them)*, 45 ARIZ. ST. L.J. 611, 614–15 (2013). These shelters “were structured to exploit, yet purportedly stay within the bounds of, the tax laws.” *Id.* at 614. A practical definition of these shelters attributed to former Treasury Assistant Secretary Eric Solomon is that they are a “tax-engineered transaction normally with little business purpose except to save taxes with minimal risk or profit potential often designed to create a tax loss without an economic loss or in some cases to make income nontaxable.” *Id.* at 615.

issues, though they do assert malpractice or professional negligence claims, since to do so would be unproductive.

Both attorneys and accountants are focused on in this study. While it might be theoretically desirable to focus on these professions separately, pragmatically this is not possible. The dividing line between the work of the tax attorney and tax accountant has always been murky.<sup>17</sup> In extending the traditional attorney-client privilege to accountants and other tax practitioners in 1998, Congress likely made the dividing line even murkier.<sup>18</sup> In many situations, the defendant tax practitioner could just as easily be from one profession as from the other.

As a framework for the ensuing discussion, Part I of this article will briefly review the general background principles governing tax malpractice, such as the elements of the cause of action and the damages recoverable. Part II will focus on the generic tax shelter cases of the past decade. Part III will then review the other tax malpractice developments of roughly the past decade. Part IV will offer concluding observations.

## I. BACKGROUND PRINCIPLES

### A. *Elements of a Malpractice Cause of Action*<sup>19</sup>

Civil actions for tax malpractice are usually based on either traditional tort or traditional contract theories.<sup>20</sup> 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.<sup>21</sup> In practice, these two standards, though emanating from different areas of the law, are virtually identical.<sup>22</sup> The professional, therefore, must exercise reasonable competence and diligence to avoid malpractice exposure.<sup>23</sup>

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<sup>17</sup> See generally, 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).

<sup>18</sup> See Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105–206 § 3411(a), 112 Stat. 685 (1998) (adding IRC § 7525).

<sup>19</sup> This section is adapted from *Malpractice I*, *supra* note 2, at 552–53, though certain footnotes have been updated.

<sup>20</sup> BERNARD WOLFMAN ET AL., STANDARDS OF TAX PRACTICE § 601.1 (6th ed. 2004).

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

<sup>23</sup> *Id.*



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.<sup>24</sup> 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.<sup>25</sup>

Normally, the malpractice tort asserted against an attorney is a specific application of the ordinary tort of negligence.<sup>26</sup> The attorney must act as a reasonably competent and careful professional would act under similar circumstances.<sup>27</sup> Since tax law generally is perceived as a specialty, the standard of care may be higher than in other attorney malpractice situations.<sup>28</sup> 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) injury suffered by the plaintiff; and (4) a proximate cause between the injury suffered and the attorney’s breach of duty.”<sup>29</sup>

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.<sup>30</sup> Many cases simply equate the elements of the causes of action and the standard of care in accountant and attorney situations.<sup>31</sup> Nevertheless, there are differences between the two professions that must be kept in mind. For

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<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> *Id.*

<sup>27</sup> *Id.* § 601.2.1.

<sup>28</sup> *See id.* § 603.3; *see also* 4 RONALD E. MALLIN & JEFFREY M. SMITH WITH ALLISON D. RHODES, LEGAL MALPRACTICE § 35:3 (2014 ed.); *Malpractice I*, *supra* note 1, at 553–54.

<sup>29</sup> WOLFMAN ET AL., *supra* note 20, § 601.2.1 (citations omitted). The essence of the cause of action is comprised of the four elements listed despite the fact that some courts sometimes list only three elements. *See, e.g.*, *Montes v. Asher & Co., C.P.A.*, 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 WL 1625617, at \*2 (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) (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 (2000).

<sup>30</sup> WOLFMAN ET AL., *supra* note 20, § 601.2.2.

<sup>31</sup> *See Malpractice I*, *supra* note 2, at 551 n.13; *see also* *Hnath v. Vecchitto*, No. X03CV930502910, 2003 WL 1995440, at \*8 (Conn. Sup. Ct. Feb. 20, 2003) (adopting same accrual of cause of action date for accountant as for attorney).

instance, there might be different statutes of limitations<sup>32</sup> 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.<sup>33</sup>

While the normal malpractice cause of action involves the tort of negligence, other torts are also encountered. *Sorenson v. H&R Block, Inc.* 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.<sup>34</sup> Alleged violations of federal securities laws<sup>35</sup> and RICO violations<sup>36</sup> may also arise, especially with generic tax shelters.

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 tax malpractice situations, allows a plaintiff to recover for all injuries proximately caused by a 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.<sup>37</sup> The most direct type of damages encountered in tax malpractice situations consist of additional taxes resulting from the malpractice, interest and penalties imposed on the additional taxes and corrective costs in attempting to

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<sup>32</sup> 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)).

<sup>33</sup> *Blair v. Ing*, 21 P.3d 452, 468, 472 (Haw. 2001) (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).).

<sup>34</sup> *Sorenson v. H&R Block, Inc.*, Civ. A. No. 99-10268-DPW, 2002 U.S. Dist. LEXIS 18689 \*3-4 (D. Mass. Aug. 27, 2002). There was also an allegation of loss of consortium. *Id.*

<sup>35</sup> WOLFMAN ET AL., *supra* note 20, § 605.2.3; *Malpractice I*, *supra* note 2, at 634.

<sup>36</sup> WOLFMAN ET AL., *supra* note 20, § 605.2.3.

<sup>37</sup> *Id.* § 605.1.1; *Malpractice I*, *supra* note 2, at 643-45.

eliminate or mitigate all or some of the foregoing damages.<sup>38</sup> As the determination of recoverable damages is a matter of state law, differences among the states exist.<sup>39</sup> While penalties and corrective costs seem to be generally recoverable, the situation concerning taxes and interest is different.<sup>40</sup> As to taxes, it seems that most states allow the recovery of any additional taxes caused by the malpractice,<sup>41</sup> though not in New York.<sup>42</sup> With regard to interest imposed on a tax underpayment, there are three approaches. One approach, which is the traditional and majority view, permits the recovery of such interest.<sup>43</sup> The second approach, which is a distinct minority view, denies the recovery of any such interest.<sup>44</sup> The third approach, which is in-between the other two and represents the most recent and growing view, permits the recovery of interest but only to the extent the interest paid the government exceeds the interest earned by the plaintiff on the underpaid taxes.<sup>45</sup>

All damages caused are recoverable, even indirect or consequential damages, as long as they are the proximate result of the defendant's negligence.<sup>46</sup> However, most courts do not award damages for emotional pain and suffering where, such as in the tax malpractice area, the basic injury suffered is only an economic one.<sup>47</sup> To be recoverable, the damages must be actually incurred, not merely speculative ones that may arise in the

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<sup>38</sup>This paragraph is adapted from Jacob L. Todres, *Tax Malpractice Damages: A Comprehensive Review of the Elements and the Issues*, 61 TAX LAW. 705, 712 (2007) [hereinafter *Tax Malpractice Damages*].

<sup>39</sup>*Id.*

<sup>40</sup>*Id.*

<sup>41</sup>*Id.* It should be emphasized that only additional taxes are addressed, not the basic taxes that are inevitably due. For instance, if the correct taxes due are \$100,000 and, due to an error by the tax return preparer, taxes of \$110,000 were paid and can no longer be recovered by simply filing an amended tax return, it is the recovery of the additional \$10,000 that is addressed.

<sup>42</sup>*Alpert v. Shea Gould Climenko & Casey*, 559 N.Y.S.2d 312, 315 (N.Y. App. Div. 1990). My view is that *Alpert* is incorrect when applied to recoveries for negligence causes of action. See *Tax Malpractice Damages*, *supra* note 38, at 714–15; Jacob L. Todres, *New York's Law of Tax Malpractice Damages: Balanced or Biased?* 86 ST. JOHN'S L. REV. 143, 160 (2012) [hereinafter *NY: Balanced or Biased*].

<sup>43</sup>Jacob L. Todres, *Recovery of Interest on a Tax Underpayment Caused by a Tax Advisor's Negligence*, 26 AKRON TAX J. 1, 3 (2011) [hereinafter *Recovery of Interest*] (tally of states following each view, *id.* at 30).

<sup>44</sup>*Id.* at 3–4.

<sup>45</sup>*Id.* at 4.

<sup>46</sup>*Tax Malpractice Damages*, *supra* note 38, at 771.

<sup>47</sup>*Id.* at 743; see, e.g., *McCulloch v. Price Waterhouse LLP*, 971 P.2d 414, 422 (Or. Ct. App. 1998).

future.<sup>48</sup> Additionally, under appropriate circumstances, a plaintiff may be entitled to recover punitive or exemplary damages.<sup>49</sup> The normal duty generally imposed upon a plaintiff, to mitigate damages resulting from a defendant's negligence, is also applicable.<sup>50</sup> Similarly, under the so called "American Rule," attorney's fees incurred to bring the malpractice action are not generally recoverable.<sup>51</sup> Such non-recoverable litigation costs should be distinguished from normally recoverable damages, such as attorney or accountant fees and other costs incurred to correct, or attempt to correct, the effects of the defendant's negligence.<sup>52</sup>

## II. GENERIC TAX SHELTERS

### A. *Introductory*

This part of the article focuses on the generic or technical tax shelters. No reported cases were located that addressed other types of shelters during the decade under review, except, perhaps, several arising in the employee benefit area that are discussed subsequently.<sup>53</sup> Although many thousands of such invalid shelters were sold,<sup>54</sup> paradoxically, there are only a handful of reported cases that address any issue that can even charitably be characterized as substantive to tax malpractice jurisprudence. Except for *Yung v. Grant Thornton LLP*,<sup>55</sup> decided in November, 2013, which reached a judgment on the merits, the statement made by a commentator in an article in 2008 that with respect to these cases there then was "not a single reported decision determining whether a particular defendant committed malpractice" is by and large still true today.<sup>56</sup>

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<sup>48</sup> See WOLFMAN ET AL., *supra* note 20, § 605.1.1.

<sup>49</sup> *Id.* § 605.1.3; see also *Yung v. Grant Thornton LLP*, No. 07-CI-2647, 201 (Ky. Cir. Ct. Nov. 8, 2013) available at <http://www.woodllp.com/Publications/Articles/pdf/Yung.pdf>. (\$80 million punitive damages).

<sup>50</sup> See WOLFMAN ET AL., *supra* note 20, § 605.2.2.

<sup>51</sup> *Id.* § 605.1.1.

<sup>52</sup> *Id.*; see also *Malpractice I*, *supra* note 2, at 644.

<sup>53</sup> See *infra* Part III.E.1.

<sup>54</sup> S. Rep. No. 108-34 at 20 (2003) (IRS data from October 2003 identified 6400 individuals and corporations that had purchased abusive tax shelters); See Joyce, *supra* note 7 (Two thousand taxpayers reportedly participated in an IRS global settlement initiative and twelve hundred in a Son of Boss settlement initiative. The extent of overlap of these numbers is unknown.).

<sup>55</sup> *Yung v. Grant Thornton LLP*, No. 07-CI-2647, 201 (Ky. Cir. Ct. Nov. 8, 2013) available at <http://www.woodllp.com/Publications/Articles/pdf/Yung.pdf>.

<sup>56</sup> Soled, *supra* note 8, at 275.

While the principles governing other types of tax malpractice would be expected to apply in this area as well—and the few cases that have addressed tax malpractice issues seem to have done so—I believe the matter is more complicated.<sup>57</sup> As described in the 2003 Senate Shelter Report, in the generic tax shelter area the tax professionals were not acting simply in their customary role as independent advisors but were often really the creators and purveyors of the shelters.<sup>58</sup> While in form they rendered opinion letters, they were really either the sellers of, or among a small group involved in the sale of, a bad product who created an elaborate scheme to defraud the purchasers.<sup>59</sup> Essentially, the opinions were used as marketing tools. The Senate report views the tax professionals involved as principals.<sup>60</sup> As such, the causes of action asserted in these situations focused more on allegations of fraud and breach of fiduciary obligations than normally encountered in other tax malpractice contexts.<sup>61</sup> Also, in light of the off-the-shelf, multiple sales of the same type of scheme to many purchasers, apart from any possible class action status, the primary focus for recovery was really the federal RICO statute with its allure of the possible recovery of treble damages plus legal fees incurred in bringing the damage suit.<sup>62</sup> Concomitant with the asserted RICO cause of action, it was also necessary to determine whether the underlying claim could be brought as a federal securities law violation, for if it could, the RICO claim was precluded.<sup>63</sup> These cases therefore involve a mix of causes of action that is different from what is usually encountered in other tax malpractice contexts.

To simplify the ensuing discussion, cases arising from generic tax shelters but involving primarily non-tax malpractice issues will be ignored, even though they may contain some tangential reference to tax

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<sup>57</sup> See, e.g., *Khan v. BDO Seidman, LLP*, 948 N.E.2d 132, 165–68 (Ill. App. Ct. 2011); *Swartz v. KPMG LLP*, 476 F.3d 756, 760–65 (9th Cir. 2007); *Seippel v. Jenkins & Gilchrist, P.C.*, 341 F. Supp. 2d 363, 374–76 (S.D.N.Y. 2004); *Loftin v. KPMG LLP*, No. 02-81166-CIV-RYSKAMP/VITUNAC, 2002 U.S. Dist. LEXIS 26909, at \*9 (S.D. Fla. December 10, 2002).

<sup>58</sup> See S. Rep. No. 108–34 at 11–12 (2003).

<sup>59</sup> *Id.* at 11–12, 20.

<sup>60</sup> See *id.*

<sup>61</sup> See *S.E.C. v. KPMG LLP*, 412 F. Supp. 2d 349, 353 (S.D.N.Y. 2006) (The S.E.C. alleged KPMG partners engaged in accounting fraud at Xerox Corporation.); *KPMG LLP v. Cocchi*, 88 So.3d 327, 329 (Fla. Dist. Ct. App. 2012) (Plaintiffs alleged negligent misrepresentation, violation of Florida Deceptive and Unfair Trade Practices Act, professional malpractice, and aiding and abetting a breach of fiduciary duty.).

<sup>62</sup> 18 U.S.C. § 1964 (2012).

<sup>63</sup> See *id.* § 1964(c).

malpractice.<sup>64</sup> Also, since the underlying fact patterns in most of the cases are very similar, even when the specific tax shelter product was different, there will not be any attempt to focus on the specific facts of each case discussed. Instead, a prototype generic tax shelter situation will be assumed based on two cases that are quite representative of this genre of cases. The pattern in these cases is remarkably similar to the situations described in the 2003 Senate Shelter Report as well as in the 2005 Senate Shelter Report.

To avoid a lengthy and distracting foray into complex and esoteric technical tax matters, there will be no attempt to delve into the underlying technical aspects of any of the generic tax shelters, though an exception is later made with respect to the recent *Yung* case.<sup>65</sup> Instead, it will be assumed herein that a patently ineffective product was sold as a supposedly viable and valid shelter. Evidence that these tax shelters were patently invalid abounds. First and foremost, after extensive investigation, the 2003 and 2005 Senate Reports on the generic shelters so concluded.<sup>66</sup> Also, when KPMG and Ernst & Young entered into criminal settlements for their involvement with these shelters, in addition to agreeing to pay very substantial amounts to the government, they admitted these shelters were fraudulent.<sup>67</sup> In addition, when the IRS started to pursue the shelter investors, most participated in various IRS settlement initiatives rather than litigating.<sup>68</sup> If there was a reasonable possibility the shelters were valid, many more of the purchasers, who by definition were quite wealthy, successful business people, could have been expected to litigate. Furthermore, if the tax shelters were even plausibly valid, it seems unlikely

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<sup>64</sup> See, e.g., *supra* notes 10-12.

<sup>65</sup> See generally *Yung v. Grant Thornton LLP*, No. 07-CI-2647, (Ky. Cir. Ct. Nov. 8, 2013) available at <http://www.woodllp.com/Publications/Articles/pdf/Yung.pdf>; See *infra* Part 2.D.

<sup>66</sup> S. Rep. No. 108-34 (2003); S. Rep. No. 109-54 (2005). The gist of both reports is that the bulk of the generic tax shelters or products are invalid.

<sup>67</sup> See I.R.S. News Release IR-2005-83 (Aug. 29, 2005) (KPMG agreed to pay \$456 million and “admitted that it engaged in a fraud that generated at least \$11 billion dollars in phony tax losses.”); Dept. of Justice, *Manhattan U.S. Attorney Announces Agreement With Ernst & Young LLP to Pay \$123 million to Resolve Federal Tax Shelter Fraud Investigation* (March 1, 2013), available at <http://www.justice.gov/usao/nys/pressreleases/March13/EYNPAPR.php?print=1>. It also should be noted that the seventh-largest U.S. accounting firm in 2011, BDO USA, admitted criminal wrongdoing in connection with its sales of tax shelters, agreed to pay \$50 million, and entered into a deferred prosecution agreement with the government. Dena Aubin, *BDO to Pay \$50 Million in Tax Shelter Case*, REUTERS (Jun. 13, 2012) <http://www.reuters.com/assets/print?aid=USL1E8HDHHV20120613>. See also Sheryl Stratton, *Nine Tax Professionals Indicted; KPMG Admits Shelters Were Fraudulent*, TAX NOTES TODAY, Aug. 30, 2005 at 167-1.

<sup>68</sup> See Joyce, *supra* note 7.

that any of the promoters would have faced anything other than some sort of civil penalty for their roles in the creation and/or sale of these shelters. Instead, a number pled guilty to criminal offenses<sup>69</sup> and others were found guilty after trial.<sup>70</sup> Finally, and very pragmatically, there were too many such products and permutations of products to even begin to attempt such an analysis. The 2003 Senate Shelter Report indicated that at one point the accounting firm of KPMG alone had almost 500 of such tax shelter products in various stages of development.<sup>71</sup>

### B. General Background

These new shelters had very exotic sounding names such as FLIP, OPIS, BLIPS, COBRA, BOSS, Son-of-BOSS, etc.<sup>72</sup> They ultimately ended up costing the government billions of dollars in lost tax revenues.<sup>73</sup> The new shelters were different from the previous types of shelters. The Senate Shelter Reports focus on two such differences. First, the prior shelters involved instances in which advantage was taken of “specific tax benefits explicitly enacted by Congress to advance a legitimate endeavor, such as the low income housing tax credit.”<sup>74</sup> Also, the Reports suggest that the

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<sup>69</sup> See, e.g., Michael Bologna, *Tax Attorney Pleads Guilty on Charges Linked to Fraudulent Tax Shelter Activities*, BNA Daily Tax Rep. No. 202 at p. K-1 (Oct. 21, 2010) (referring to guilty pleas by Erwin Mayer (former Jenkins & Gilchrist partner), Charles W. Bee Jr. (former BDO Seidman vice chairman) Michael Kerekes (former BDO Seidman principal), Adrian Dicker (former BDO Seidman vice chairman), Robert Greisman (former BDO Seidman partner) and Mark Bloom (former BDO Seidman partner.); Andrew Velarde & Kristen A. Parillo, *Daugerdas Convicted of Tax Shelter Charges*, Tax Notes 574 (Nov. 11, 2013) (Donna Guerin (former Jenkins & Gilchrist partner) pled guilty after having a prior conviction overturned due to juror misconduct.).

<sup>70</sup> See Velarde & Parillo, *supra* note 69, at 574 (among those convicted are Paul M. Daugerdas, former Jenkins & Gilchrist partner); see also *Second Circuit Affirms Convictions of Former KPMG Executives, Finds Error Regarding Fine*, BNA Daily Tax Rep. No. 166 at p. K-3 (Aug. 30, 2010) (refers to convictions of Robert Pfaff (former KPMG tax partner), John Larson (former KPMG senior tax manager) and Raymond J. Ruble (former Brown & Wood partner)).

<sup>71</sup> S. Rep. No. 108-34, at 3 (2003).

<sup>72</sup> The acronyms stood for: Foreign Leveraged Investment Program (FLIP), Offshore Portfolio Investment Strategy (OPIS), Bond Linked Issue Premium Structure (BLIPS), Bond and Options Sales Strategy (BOSS), Currency Options Bring Reward Alternatives (COBRA). S. Rep. No. 108-34, at 3 (2003) (FLIP, OPIS and BLIPS); S. Rep. No. 109-54, at 78 (2005) (COBRA), 88 (BOSS).

<sup>73</sup> In testimony before the Senate Finance Committee the U.S. General Accounting Office estimated the potential tax loss as of September 30, 2003 at \$85 billion. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-04-104T, INTERNAL REVENUE SERVICE CHALLENGES REMAIN IN COMBATING ABUSIVE TAX SHELTERS 11 (2003).

<sup>74</sup> S. Rep. No. 108-34, at 2 (2003).

prior shelters involved a response by a tax professional to an inquiry by a single client.<sup>75</sup> In contrast, according to the Reports, the new shelters were complex transactions with no economic substance or business purpose other than the reduction of taxes.<sup>76</sup> Also, the new shelters involved “generic tax products” affirmatively developed by a firm and marketed to numerous potential buyers.<sup>77</sup> The 2003 Report further bemoaned the fact that “[d]ubious tax shelter sales . . . [were] no longer the province of shady, fly-by-night companies” but instead became big business involving top professionals from the country’s largest accounting and law firms, investment advisory firms, and banks.<sup>78</sup>

To somewhat concretize how the generic tax shelters worked, assume a taxpayer sold his business and realized a very large gain. If the taxpayer did not seek out a tax shelter on his own, an accountant,<sup>79</sup> banker,<sup>80</sup> or someone else aware of the large impending gain might introduce the taxpayer to a seller of shelters who was often an accounting firm,<sup>81</sup> banker<sup>82</sup> or financial advisor.<sup>83</sup> After being repeatedly assured that the shelter was completely legal and valid and that opinions to this effect would later be available from either a CPA firm and prominent law firm or from several prominent law firms, the taxpayer would agree to purchase the shelter at a very significant cost. The legal opinion(s) often required additional fees. After purchasing the shelter and signing the documentation presented to him or her, a series of transactions would be orchestrated by the shelter seller with the aid of one or more banks (to make loans) and certain other intermediaries/facilitators to take whatever steps were to be performed. The taxpayer was passive and had no real understanding or involvement in what was happening. While some taxpayers might have been told there was a chance

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<sup>75</sup> *Id.* See also S. Rep. No. 109-54, at 9 (2005). This seems to ignore the fact that previously there were syndicators who sold shelters to a number of customers.

<sup>76</sup> S. Rep. No. 108-34, at 2 (2003); S. Rep. No. 109-54, at 1 (2005).

<sup>77</sup> S. Rep. No. 108-34, at 2 (2003); S. Rep. No. 109-54, at 1 (2005).

<sup>78</sup> S. Rep. No. 108-34, at 5 (2003).

<sup>79</sup> See, e.g., *Seippel v. Jenkins & Gilchrist, P.C.*, 341 F. Supp. 2d 363, 368–69 (S.D.N.Y. 2004) *amended on reconsideration*, 03 CIV. 6942 (SAS), 2004 WL 2403911 (S.D.N.Y. Oct. 26, 2004).

<sup>80</sup> See, e.g., *Loftin v. KPMG LLP*, No. 02-81166-CIV-RYSKAMP/VITUNAC, 2002 U.S. Dist. LEXIS 26909, at \*4 (S.D. Fla. Dec. 10, 2002).

<sup>81</sup> See, e.g., *Seippel*, 341 F. Supp. 2d at 363; *Loftin*, 2002 U.S. Dist. LEXIS 26909, at \*4.

<sup>82</sup> See, e.g., *RA Inves. I, LLC v. Deutsche Bank AG*, No. Civ. A. 3:04-CV-1565-G, 2005 WL 1356446, at \*1 (N.D. Tex. June 6, 2005).

<sup>83</sup> See, e.g., *Carroll v. LeBoeuf, Lamb, Greene & MacRae, LLP*, 623 F. Supp. 2d 504, 507 (S.D.N.Y. 2009).



of actually earning real money from the shelters, most were only interested in obtaining the large losses that had been promised to offset the income that was sought to be sheltered. These losses were then reported on the appropriate tax returns. While the transactions may or may not have actually been effectuated, there was no real business purpose for them, they involved no real risk of loss nor possibility of gain, and they did not have any real economic consequences to the taxpayer apart from generating the promised tax losses.

Many different promoters sold a number of different types of tax shelters. While there were differences in precisely how each promoter structured and effectuated the transactions, essentially most of the technical generic tax shelters were fundamentally very similar. The Senate Committee's detailed description of what occurred in one type of transaction is therefore quite informative of how most of the shelters operated at the basic level.

The 2003 Senate Shelter Report focused on four shelters developed and marketed by the big four accounting firm of KPMG, which was probably the largest purveyor of the generic shelters.<sup>84</sup> In analyzing the circumstances surrounding the development and sale of these tax shelter products, the Report indicated that KPMG's involvement with the product did not end with the sale of the product.<sup>85</sup> Complex financial steps and investment activities needed to be performed to effectuate the shelter transactions and KPMG enlisted the intermediaries and helped orchestrate all the necessary steps.<sup>86</sup> With respect to the tax opinion letters, the Report noted that KPMG worked closely with the law firm of Sidley Austin Brown & Wood, which issued over 600 opinion letters supporting 13 questionable shelter products.<sup>87</sup> KPMG initially prepared a prototype tax opinion for each of the products, which then became the template for the opinion letters it issued to its clients.<sup>88</sup> It collaborated with the law firm before selling any product to

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<sup>84</sup>S. Rep. No. 108-34, at 3 (2003). It was indicated that at one point KPMG had over 500 of such tax products in inventory. *Id.*

<sup>85</sup>*Id.* at 9.

<sup>86</sup>*Id.*

<sup>87</sup>*Id.* at 10–11. Actually the Brown & Wood law firm was involved with the shelters. S. Rep. No. 109-54, at 96 (2005). It later merged with the Sidley Austin firm with the surviving firm called Sidley Austin Brown & Wood. Apparently the Sidley Austin firm was not involved with these shelters, though, after the merger, some work of this type was still engaged in by certain of the old Brown & Wood attorneys (R.J. Ruble) contrary to the policy of the new firm to no longer engage in such work. *Id.* at 100.

<sup>88</sup>S. Rep. No. 108-34, at 11 (2003).

assure the law firm would supply a favorable opinion letter.<sup>89</sup> KPMG and Sidley actually exchanged copies of their draft opinions, and their opinions ended up having numerous identical paragraphs.<sup>90</sup> KPMG directed its shelter clients to Sidley, which provided nearly identical opinions to the clients that included no individualized legal advice.<sup>91</sup> In many cases Sidley issued the opinion without ever having spoken to the client.<sup>92</sup> Also, the factual representations underlying the opinions, which purportedly were made by the client, KPMG, the intermediary financial advisors/facilitators and the banks, were actually drafted by KPMG.<sup>93</sup> Many of the important representations made by the clients, such as that they independently investigated the transactions and believed there was a reasonable opportunity to earn a profit, were drafted by KPMG and were false.<sup>94</sup> In addition, there was evidence that with respect to one of the four shelter products focused on by the Senate Report, Sidley was paid a fee whenever a client was simply informed that a second opinion letter endorsing the validity of the product was available from Sidley, even if the client never purchased the opinion letter.<sup>95</sup> In light of the relationship between KPMG and Sidley, the Senate Report's conclusion in this portion of the Report seems somewhat understated: "This type of close, ongoing, and lucrative collaboration raises serious questions about the independence of both parties and the value of their opinion letters in light of the financial stake that both firms had in the sale of the tax product being analyzed."<sup>96</sup>

Once the IRS realized the extent and nature of the generic tax shelter epidemic, it proceeded with a carrot and stick approach. For the stick, as it became aware of the different types of shelters being marketed, it issued announcements designating them as listed transactions, thereby imposing requirements on taxpayers utilizing such shelters to report on their tax returns their participation in such tax shelters<sup>97</sup>—thereby pretty much

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<sup>89</sup> *Id.*

<sup>90</sup> *Id.* at 11–12.

<sup>91</sup> *Id.* at 12.

<sup>92</sup> *Id.*

<sup>93</sup> *Id.*

<sup>94</sup> *Id.*

<sup>95</sup> *Id.*

<sup>96</sup> *Id.*

<sup>97</sup> I.R.C. § 6011 (2012). The early Notices issued by the IRS that are mentioned in a number of the cases are I.R.S. Notice 99-59, 1999-2 C.B. 761 (Tax Avoidance Using Distributions of Encumbered Property) ("BOSS Notice"); and I.R.S. Notice 2000-44, 2000-2 C.B. 255 (Tax Avoidance Using Artificially High Basis) ("Son of BOSS" Notice). Examples of other Notices are

assuring an audit. The designation also imposed record-keeping requirements on the promoters and sellers.<sup>98</sup> The IRS also announced repeatedly it would vigorously pursue shelter participants.<sup>99</sup> In tandem with these steps, the IRS periodically issued disclosure or settlement initiatives whereby those taxpayers who would either voluntarily come forth and disclose their participation in certain shelters or who would agree to settle based on the terms of the initiative would obtain favorable settlement terms.<sup>100</sup> These initiatives required full payment of any tax underpayments together with interest, but typically would waive all or some portion of the full forty-percent penalty.<sup>101</sup> Many taxpayers took advantage of these initiatives.<sup>102</sup> Thus, when a tax shelter product was designated by the IRS as a reportable transaction, or when it was the subject of an IRS disclosure or settlement initiative, another issue or set of issues arose. The issues concern whether the tax professionals and /or the others involved in selling the tax shelters were obligated to inform the purchasers of the IRS designation or initiative, whether they did or did not inform the tax purchasers about these designations or initiatives, and whether any advice they rendered in this regard was proper.<sup>103</sup>

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I.R.S. Notice 2004-30, 2004-1 C.B. 828 (S Corporation Tax Shelter); I.R.S. Notice 2002-65, 2002-2 C.B. 690 (Passthrough Entity Straddle Tax Shelter); and I.R.S. Notice 2001-45, 2001-2 C.B. 129 (Basis Shifting Tax Shelter).

<sup>98</sup>I.R.C. §§ 6111–6112 (2012).

<sup>99</sup>See, e.g., I.R.S. News Release, *Tax Day Reminder: Treasury & IRS Continue Crackdown on Abusive Tax Shelters*, IR-2003-51 (Apr. 15, 2003); I.R.S. News Release, *Strong Response to “Son of Boss” Settlement Initiative*, IR-2004-87 (Jul. 1, 2004) (“We will vigorously pursue all those who participated in Son of Boss deals but did not take advantage of the settlement initiative.” (quoting Commissioner Everson)) (“For those who haven’t come forward and intend to take the IRS to court, we plan an aggressive litigation strategy.” (quoting IRS Chief Counsel Don Korb)); I.R.S. Announcement 2002-96, 2002-2 C.B. 756 (“The Service will vigorously defend or prosecute all future COLI [corporate owned life insurance] litigation.”).

<sup>100</sup>See, e.g., IRS Announcement 2002-2, 2002-1 C.B. 304 (disclosure initiative – section 6662(b) (1)–(4) penalties waived for taxpayers who disclose participation in tax shelters); IRS Announcement 2005-80, 2005-2 C.B. 967 (settlement initiative for a number of shelters); IRS Announcement 2002-97, 2002-2 C.B. 757 (settlement initiative for basis-shifting transactions).

<sup>101</sup>See, e.g., IRS Announcement 2002-2, 2002-1 C.B. 304; IRS Announcement 2005-80, 2005-2 C.B. 967; IRS Announcement 2002-97, 2002-2 C.B. 757.

<sup>102</sup>See Joyce, *supra* note 7.

<sup>103</sup>See, e.g., *Khan v. BDO Seidman, LLP*, 948 N.E.2d 132, 144 (Ill. App. Ct. 2011) (accountant advised plaintiff not to participate in amnesty program); *Swartz v. KPMG LLP*, 476 F.3d 756, 760 (9th Cir. 2007) (accountant and attorney advised plaintiff to participate in amnesty program); *Olson v. Jenkins & Gilchrist*, 461 F. Supp. 2d 710, 716 (N.D. Ill. 2006) (defendants advised plaintiffs not to participate in amnesty program); *RA Invs. I, LLC v. Deutsche Bank AG*,

### C. Prototype Generic Tax Shelter Scenario

*Loftin v. KPMG LLP*<sup>104</sup> is a good illustration of the operation of a generic tax shelter. In *Loftin*, the plaintiff sold stock in 1997 and 1999 and netted capital gains of \$30 million and \$65 million, respectively.<sup>105</sup> On depositing the proceeds from the 1997 sale, the plaintiff's banker encouraged him to retain the accounting firm of KPMG for tax planning purposes regarding the \$30 million capital gains.<sup>106</sup> The plaintiff met with KPMG and was presented with the FLIP (Foreign Leveraged Investment Program) tax planning strategy.<sup>107</sup> If effective, the FLIP strategy would generate large capital losses to offset the capital gains, thereby saving Loftin the tax on the capital gains.<sup>108</sup> KPMG assured the plaintiff that the FLIP strategy complied with IRS rules and regulations and would withstand an IRS audit.<sup>109</sup> The plaintiff decided to use the FLIP strategy.<sup>110</sup> He then retained KPMG as well as another firm knowledgeable about the strategy to act as intermediary.<sup>111</sup> KPMG required him to retain this intermediary to implement the strategy.<sup>112</sup> KPMG was also retained to prepare his 1997 tax return.<sup>113</sup> The FLIP strategy was implemented in a number of steps taken from September 16, 1997 to December 22, 1997.<sup>114</sup> In June of 1998, the plaintiff received opinions from KPMG and the law firm of Brown & Wood that the FLIP strategy was "more likely than not" to be considered

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No. Civ.A.3:04-CV-1565-G, 2005 WL 1356446, at \*3 (N.D. Tex. June 6, 2005 (some plaintiffs not informed of amnesty program, others advised not to participate); *Stechler v. Sidley, Austin Brown & Wood, L.L.P.*, 382 F. Supp. 2d 580, 586 (S.D.N.Y. 2005)(attorneys advised plaintiff of amnesty program and advised them to consult with their accountants who advised against participation).

<sup>104</sup> See generally *Loftin v. KPMG LLP*, No. 02-81166-CIV-RYSKAMP/VITUNAC, 2002 U.S. Dist. LEXIS 26909 (S.D. Fla. Dec. 10, 2002). The discussion of *Loftin* is adapted from Jacob L. Todres, *Investment In A Bad Tax Shelter: Malpractice Recovery From The Tax Advisor Is No Slam-Dunk*, Tax Notes, April 11, 2005 p. 217, 219, 225–26.

<sup>105</sup> *Loftin*, 2002 U.S. Dist. LEXIS 26909 at \*4,\*7.

<sup>106</sup> *Id.* at \*4.

<sup>107</sup> *Id.* \*4–5. It should be noted that *Loftin* also referred to a BLIP shelter strategy for 1999, but never discussed nor described the BLIP strategy. *Id.* at \*7–8.

<sup>108</sup> *Id.* at \*5.

<sup>109</sup> *Id.* at \*5.

<sup>110</sup> *Id.*

<sup>111</sup> *Id.* at \*4–5.

<sup>112</sup> *Id.* at \*7.

<sup>113</sup> *Id.* at \*4–5.

<sup>114</sup> *Id.* at \*5–6.

proper.<sup>115</sup> A similar scenario occurred in 1999 regarding the plaintiff's 1999 capital gains.<sup>116</sup>

The FLIP strategy proved ineffective. The IRS commenced an audit of the plaintiff's 1997 tax return in October 2000<sup>117</sup> and later issued an announcement challenging the efficacy of all such types of transactions.<sup>118</sup> KPMG encouraged the plaintiff to settle with the IRS.<sup>119</sup>

Loftin later filed suit again KPMG, Brown & Wood, and the other participants in the FLIP strategy.<sup>120</sup> The complaint included allegations of fraud, breach of fiduciary duty, negligent misrepresentation, malpractice against KPMG and Brown & Wood, and a RICO claim.<sup>121</sup> Most of the court's opinion in *Loftin* addressed whether the RICO claim was barred by the Private Securities Litigation Reform Act of 1995 and ultimately held that it was.<sup>122</sup> Insofar as the other causes of action were concerned, the court held all of them were premature because Loftin had not yet settled with the IRS and therefore there were no damages, the presence of which was an essential element for all the other causes of action.<sup>123</sup>

*Seippel v. Jenkins & Gilchrist, P.C.* is similar to *Loftin* and illustrates both the typical generic tax shelter scenario and also many of the legal issues raised in this area.<sup>124</sup> In *Seippel*, William Seippel was a senior executive at a Virginia company.<sup>125</sup> In 1999, Mr. Seippel was planning to change jobs.<sup>126</sup> In connection with the change, he exercised stock options and sold the resulting stock for a gain of at least \$12 million.<sup>127</sup> Ernst & Young was his employer's auditor and had provided tax advice and financial services to the senior executives of his employer, including Mr.

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<sup>115</sup> *Id.* at \*7.

<sup>116</sup> *See id.* at \*7–8.

<sup>117</sup> *Id.* at \*8.

<sup>118</sup> I.R.S. Notice 2001-45, 2001-2 C.B. 129.

<sup>119</sup> *Loftin*, 2002 U.S. Dist. LEXIS 26909, at \*8.

<sup>120</sup> *See id.*

<sup>121</sup> *Id.* at \*8–9.

<sup>122</sup> *Id.* at \*10–21.

<sup>123</sup> *Id.* at \*21–25 (fraud and negligent misrepresentation); \*25–27 (breach of fiduciary duty); \*27–29 (malpractice).

<sup>124</sup> *See generally* *Seippel v. Jenkins & Gilchrist, P.C.*, 341 F. Supp. 2d 363 (S.D.N.Y. 2004) *amended on reconsideration*, 03 CIV. 6942 (SAS), 2004 WL 2403911 (S.D.N.Y. Oct. 26, 2004).

<sup>125</sup> *Id.* at 368.

<sup>126</sup> *Id.*

<sup>127</sup> *Id.* at 368–69.

Seippel.<sup>128</sup> Ernst & Young therefore knew of Mr. Seippel's plans and of his substantial taxable gain.<sup>129</sup>

Late in 1999, Ernst & Young convinced Mr. Seippel to engage in a COBRA ("Currency Options Bring Reward Alternatives") tax shelter transaction involving the purchase and sale of options on foreign currency to shield his \$12 million gain from taxation.<sup>130</sup> According to the complaint, Ernst & Young convinced Mr. Seippel that the COBRA shelter was completely legal and even conservative.<sup>131</sup> He was informed by Ernst & Young that it had developed the COBRA shelter and that two blue-chip law firms, *Jenkins & Gilchrist*<sup>132</sup> and *Brown & Wood*, would provide opinion letters as to the propriety of the COBRA shelter.<sup>133</sup>

From the opinion it appears that the various steps of the COBRA transaction (really a number of transactions) were effectuated during December 1999.<sup>134</sup> Defendant Deutsche Bank was used to effectuate some of the transactions.<sup>135</sup> In February 2000, Mr. Seippel received an opinion letter from *Jenkins & Gilchrist* stating that the \$12 million of losses generated by the COBRA transactions were legally deductible.<sup>136</sup> A similar opinion was received from *Brown & Wood* in March 2000 that also indicated that the IRS should not be able to successfully assert any penalties as a result of the tax positions taken by Mr. Seippel in the COBRA transactions.<sup>137</sup> Ernst & Young prepared the 1999 and 2000 tax returns for Mr. and Mrs. Seippel reporting the COBRA transactions.<sup>138</sup>

On December 27, 1999, the IRS issued Notice 1999-59 informing the public that "certain types of transactions . . . being marketed to taxpayers for the purpose of generating . . . artificial losses are not allowable for

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<sup>128</sup> *Id.* at 368.

<sup>129</sup> *Id.* at 368-69.

<sup>130</sup> *Id.* at 369.

<sup>131</sup> *Id.*

<sup>132</sup> As part of its settlement with the government for its role in the proliferation of fraudulent generic tax shelters, in addition to agreeing to pay a fine of \$76 million, *Jenkins & Gilchrist* agreed to disband. See I.R.S. News Release IR-2007-71 (Mar. 29, 2007); Press Release, U.S. Attorneys Office, S. Dist. of N.Y., U.S. Attorney Enters Non-prosecution Agreement with *Jenkins & Gilchrist* in Connection with its Fraudulent Tax Shelter Activity (Mar. 28, 2007).

<sup>133</sup> *Seippel*, 341 F. Supp. 2d at 369.

<sup>134</sup> *Id.*

<sup>135</sup> *Id.*

<sup>136</sup> *Id.*

<sup>137</sup> *Id.*

<sup>138</sup> *Id.* at 370.

federal income tax purposes.<sup>139</sup> The plaintiff alleged that Notice 1999-59 likely applied to the COBRA transaction.<sup>140</sup> The plaintiff further alleged that Notice 2000-44, released on September 5, 2000, specified that the precise transaction marketed as the COBRA transaction was not properly allowable for tax purposes.<sup>141</sup> In all the communications Mr. Seippel received from the defendants the only mention of either of these Notices was contained in the Jenkens & Gilchrist opinion letter, which stated only that Notice 1999-59 did not apply to the COBRA transactions.<sup>142</sup>

In March 2002 Ernst & Young informed Mr. Seippel that it had received subpoenas in connection with an IRS investigation of COBRA.<sup>143</sup> Mr. Seippel retained new tax and legal advisers in July 2002 and then discovered the alleged fraud.<sup>144</sup> The present suit was commenced on September 10, 2003.<sup>145</sup>

The allegations against the defendants in *Seippel* are representative of the generic shelter area. According to the complaint, the attorney defendants, Jenkens & Gilchrist<sup>146</sup> and Brown & Wood, actually developed and promoted the COBRA shelter as well as many other tax shelters.<sup>147</sup> To operate, market and promote these shelters they entered into an alliance with a number of accounting and financial services firms.<sup>148</sup> They had the accountant, here Ernst & Young, assert that it had developed the shelter to give the impression that the attorneys were exercising independent judgment in rendering their opinions.<sup>149</sup> That also enabled both attorneys to charge substantial fees for what were essentially “canned” opinions requiring little, if any, additional work.<sup>150</sup> The opinion letters would attest to

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<sup>139</sup> I.R.S. Notice 99-59, 1999-2 C.B. 761.

<sup>140</sup> *Seippel*, 341 F. Supp. 2d at 368.

<sup>141</sup> *Id.*

<sup>142</sup> *Id.* at 369–70.

<sup>143</sup> *Id.* at 370.

<sup>144</sup> *Id.*

<sup>145</sup> *Id.* at 366.

<sup>146</sup> Although the Jenkens & Gilchrist defendants were important participants in the events in issue, all claims against them were stayed because of the class action litigation then in progress against them and only the other defendants participated in those proceedings. *Id.*, n.2.

<sup>147</sup> *Id.* at 367.

<sup>148</sup> *Id.*

<sup>149</sup> *Id.* at 367.

<sup>150</sup> *Id.* at 367–68. Allegedly, the lawyer defendants agreed that on some transactions one of the firms would receive very substantial fees while the other would receive relatively nominal fees and that in other transactions the lawyers’ roles would be reversed. *Id.* at 368. In *Seippel*, the fees

the legitimacy of the shelter and if the shelters were found to be invalid, protect the participants from the imposition of penalties by the tax authorities. In what seems like a very macabre twist that could only protect the attorneys from liability while undercutting the value of the opinion letters, the defendants would receive the opinion letters only after they had engaged in the shelter transactions.<sup>151</sup> Also, the accountant, here Ernst & Young, or other firm soliciting prospective shelter participants, allegedly was to over-represent the positives of the shelter (*i.e.*, it was “100 percent legitimate”) while understating risks, such as by failing to disclose authority to the contrary.<sup>152</sup> Finally, the defendants allegedly agreed among themselves that the accounting firm would assert to potential participants that the proposed shelter transaction was proprietary and confidential and could not be taken to the potential participant’s attorney or accountant for independent review.<sup>153</sup>

In *Seippel*, the plaintiff sought to recover the following types of damages: (1) cost of retaining tax and legal advisors to discover the fraud and to rectify the problems created by their participation in the shelter; (2) additional federal and Virginia taxes they were promised they would not have to pay; (3) interest and/or penalties on the underpaid taxes; (4) losses incurred when they had to liquidate assets at fire sale prices to meet their tax obligations; and (5) loss of alternative legitimate tax saving opportunities.<sup>154</sup> He also sought rescission of his fee agreement with the defendants and recovery of the fees paid.<sup>155</sup>

The causes of action asserted in *Seippel* are typical of those asserted in the generic shelter cases. They include assertion of RICO act violations and recoveries for breach of fiduciary duties, inducing breach of fiduciary duties, fraud, negligent misrepresentation, breach of contract, malpractice, unethical, excessive illegal and unreasonable fees and unjust enrichment.<sup>156</sup> The complaint brought in federal district court involved both federal and state law questions.<sup>157</sup>

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paid to the lawyers were \$338,880 to Jenkens & Gilchrist and \$21,180 to Brown & Wood. *Id.* at 370.

<sup>151</sup> *Id.* at 367–68.

<sup>152</sup> *Id.* at 368.

<sup>153</sup> *Id.*

<sup>154</sup> *Id.* at 370.

<sup>155</sup> *Id.* at 380.

<sup>156</sup> *Id.* at 366.

<sup>157</sup> *Id.*



*D. Cases*

In focusing on the professional malpractice causes of action in the generic tax shelter area, a threshold issue immediately arises. While the rendition of incorrect tax advice could certainly be the basis for a malpractice suit against an attorney or accountant, could it be the basis for a suit against another type of professional? The issue arises because in a number of instances the sellers of the shelters were financial advisors, banks or other non-accountants and non-attorneys. Similarly, banks and other intermediaries were involved in virtually all of these transactions. If for some reason they could not be held liable under another cause of action, could they be held liable under the malpractice cause of action? This issue depends on state law and differences among the states are likely. In a non-generic tax shelter case involving incorrect tax advice given by an insurance agent/financial planner, a federal district court specifically sidestepped the issue of whether New York law recognized a professional malpractice cause of action against financial advisors.<sup>158</sup>

This issue arose in *Khan v. BDO Seidman, LLP*, and the court held such a suit against another professional was permissible.<sup>159</sup> In *Khan*, the plaintiffs purchased tax shelters in 1999 and 2000 from its auditors, defendant BDO Seidman.<sup>160</sup> The present case involved only Deutsche Bank, which acted as an investment bank that entered into certain option transactions with the plaintiffs, and the accounting firm of Grant Thornton, LLP, which had reported certain of the shelter losses on the tax return of one of the plaintiffs' corporations, which losses then flowed through to the plaintiffs' tax returns.<sup>161</sup> At the trial court, the causes of action against these two defendants were dismissed on statute of limitations grounds.<sup>162</sup> On this appeal, the appellate court reversed the dismissal on statute of limitations grounds.<sup>163</sup> The Deutsche Bank defendants argued that the Illinois malpractice rules did not apply to them because they were not accountants.<sup>164</sup> They argued that "tax advice, even if given negligently, cannot rise to a malpractice claim unless given by a *professional tax*

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<sup>158</sup>*Solin v. Domino*, No. 08 Civ. 2837(SCR), 2009 U.S. Dist. LEXIS 51405, at \*11–12 n.7 (S.D.N.Y. Feb. 25, 2009).

<sup>159</sup>948 N.E.2d 132, 165 (Ill. App. Ct. 2011), *aff'd*, 978 N.E.2d 1020 (2012).

<sup>160</sup>*Id.* at 136.

<sup>161</sup>*Id.*

<sup>162</sup>*Id.* at 136–37.

<sup>163</sup>*Id.* at 137.

<sup>164</sup>*Id.* at 164.

advisor.”<sup>165</sup> The court gave short shrift to this argument and held that “[o]ne does not have to be an accountant to incur liability for giving negligent tax advice.”<sup>166</sup> The court adopted the position of the Restatement (Second) of Torts that liability is incurred if six conditions are met:

- (1) the defendants gave the tax advice in the course of their business or in a transaction in which they had a pecuniary interest;
- (2) the defendants gave the tax advice for the plaintiff’s guidance in his business transactions;
- (3) the tax advice was false;
- (4) the defendant failed to exercise reasonable care or competence in obtaining the tax information or in communicating it to the plaintiff;
- (5) the plaintiff justifiably relied on the tax advice; and
- (6) the plaintiff suffered pecuniary loss as a consequence.<sup>167</sup>

Other fundamental issues that must be carefully delineated in the malpractice context are the role of the tax professional and exactly when the tax professional became involved in the transaction. While the Senate Shelter Reports investigating the generic tax shelter phenomenon seemed to focus on instances in which the accountant or the attorney was really in the group creating and marketing the shelters and was not acting as an independent professional, this is not how all such situations occurred.<sup>168</sup> It is certainly possible, and even likely, that a potential purchaser of a shelter would retain an independent professional to review the proposed transaction and advise whether it was effective. In *Carroll v. LeBoeuf, Lamb, Green & MacRae, L.L.P.*, after deciding to participate in a tax shelter for 2001, the plaintiffs engaged an accountant to review the shelter, provide independent and objective advice of the tax risks, advise on proper tax treatment, and prepare the plaintiffs’ personal federal and New Jersey tax returns for 2001 and 2002.<sup>169</sup> The individual accountant was retained in November 2001 and, in the first half of 2002, became affiliated with an accounting firm that

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<sup>165</sup> *Id.* at 164–65.

<sup>166</sup> *Id.* at 165.

<sup>167</sup> *Id.* (citing Restatement (Second) of Torts § 552 (1) (1977)).

<sup>168</sup> See generally S. Rep. No. 108-34 (2003); S. Rep. No. 109-54, at 1 (2005).

<sup>169</sup> 392 F. Supp. 2d 621, 624 (S.D.N.Y. 2005).

was one of the defendants in this litigation.<sup>170</sup> In denying the defendant accounting firm's motion to dismiss the complaint against it, the court did hold that there was no basis to hold the defendant accounting firm liable for the two investments in the shelter scheme made before the defendant came onto the scene in the first half of 2002.<sup>171</sup> They could, however, face potential liability for the plaintiffs' later investment that was made after they were advising the plaintiffs.<sup>172</sup>

In *Williams v. Sidley Austin Brown & Wood, L.L.P.*, the court also took careful note of when the attorney-client relationship arose.<sup>173</sup> The court held this occurred on March 8, 2002, after the plaintiff purchased the shelter in late 2001, but before the tax return for 2001 was filed.<sup>174</sup> The court granted defendant Sidley Austin's motion to dismiss a fraud and fraud-related causes of action that predated the attorney-client relationship.<sup>175</sup> However, it refused to dismiss a malpractice cause of action against Sidley Austin based on actions occurring after the attorney-client relationship arose, since the relationship imposed duties and responsibilities on the attorney that did not previously exist.<sup>176</sup> Quite properly, in this portion of the opinion when the court referred to potential damages that might be recoverable, it included only damages arising from claiming improper deductions on a tax return, but none relating to the cost of purchasing the invalid tax shelter.<sup>177</sup>

In *Affco Investments, LLC v. KPMG, LLP*, after investing in a tax shelter, but before reporting the losses on their tax return, the plaintiffs became concerned that under two notices recently issued by the IRS they would need to report their participation in the shelter on their tax return.<sup>178</sup> After the first notice was issued they obtained an opinion from the New York law firm of Proskauer Rose LLP that the plaintiffs' transactions were not substantially similar to any transactions prohibited by the IRS and that it was therefore unnecessary to report the shelter transaction on their tax return.<sup>179</sup> After the second IRS notice, the plaintiffs obtained a supplemental opinion from Proskauer reaffirming the continued validity of the original

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<sup>170</sup> *Id.*

<sup>171</sup> *Id.* at 627.

<sup>172</sup> *Id.* at 627–28.

<sup>173</sup> No. 600808/05, 2006 WL 684599, at \*5 (Sup. Ct. N.Y. Cty. Mar. 13, 2006).

<sup>174</sup> *Id.* at \*3.

<sup>175</sup> *Id.* at \*7.

<sup>176</sup> *Id.*

<sup>177</sup> *Id.* at \*7–8.

<sup>178</sup> No. H-07-3379, 2009 WL 3248052, at \*2 (S.D. Tex. Sept. 28, 2009).

<sup>179</sup> *Id.*

opinion.<sup>180</sup> The plaintiffs followed this advice, which was consistent with the advice they received from the seller of the shelter, KPMG, and the Sidley law firm, and claimed the shelter losses on their tax returns but did not report their participation in the shelter on their tax returns.<sup>181</sup> As a consequence, they eventually ended up paying additional taxes, interest and penalties.<sup>182</sup> Because they did not report their participation in the tax shelter on their tax returns, they were ineligible to participate in the IRS amnesty program for this type of shelter.<sup>183</sup> The opinion did not address the substance of this claim, since the court dismissed all federal causes of action asserted against Proskauer and declined to exercise supplemental jurisdiction over the state law claims.<sup>184</sup>

As noted previously, at various times the IRS made amnesty and settlement offers to taxpayers who utilized various types of generic tax shelters.<sup>185</sup> A number of cases mentioned whether the tax advisor did or did not inform the plaintiffs of these programs and whether they advised them to participate in these programs.<sup>186</sup> However, none of the cases reached the stage of focusing on the substantive repercussions of the tax advisor's conduct in this regard. The issue did arise but in a rather unusual posture in *Rosenbach v. The Diversified Group, Inc.*<sup>187</sup> In *Rosenbach*, the plaintiffs were successful in an arbitration proceeding against the sellers of a bad tax shelter.<sup>188</sup> The defendants then brought a third party claim for contribution against the plaintiffs' tax counsel and plaintiffs' accounting firm that filed the tax return on which the shelter loss was reported.<sup>189</sup> The claim against the tax counsel was that it failed to disclose material information to the plaintiffs in advising the plaintiffs whether to apply for amnesty.<sup>190</sup> The claim against the accounting firm was that it lacked a reasonable basis for

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<sup>180</sup> *Id.*

<sup>181</sup> *Id.*

<sup>182</sup> *Id.*

<sup>183</sup> *Id.*

<sup>184</sup> *Id.* at \*6.

<sup>185</sup> See *supra* text accompanying notes 97–103.

<sup>186</sup> See *supra* cases cited at note 103. See also *Carlisle v. Curtis, Mallet-Prevost, Colt & Mosle LLP*, 521 F.3d 597, 599 (6th Cir. 2008), *rev'd sub nom. Arthur Andersen LLP v. Carlisle*, 556 U.S. 624 (2009).

<sup>187</sup> 926 N.Y.S.2d 49 (N.Y. App. Div. 2011).

<sup>188</sup> *Id.* at 50.

<sup>189</sup> *Id.* 50–51.

<sup>190</sup> *Id.* at 52 (The alleged material omission was asserted to remove the issue from the ambit of the “error in judgment” rule).

believing the tax shelter loss was valid and would be accepted by the IRS.<sup>191</sup> While it seems ludicrous and the height of “chutzpah” for the seller of a bad tax shelter who repeatedly vouched for the efficacy of the shelter to be able to claim the purchasers’ tax return preparer should have known better than to believe him, the New York intermediate appellate court affirmed the trial court’s denial of the third party defendants’ motion to dismiss this claim for contribution.<sup>192</sup>

One aspect of *Carroll v. LeBoeuf, Lamb, Greene & MacRae, LLP* is worthy of note.<sup>193</sup> *Carroll* involved the final stage in a litigation by the purchasers of a bad tax shelter.<sup>194</sup> The action was resolved against all defendants other than the promoter (and two related corporations) who sold the shelter to the plaintiffs.<sup>195</sup> It did not involve any tax professionals. The court granted the defendants’ motion for summary judgment, dismissing the complaint because the plaintiffs did not establish their fraud claim against the defendant.<sup>196</sup> In discussing the viability of the fraud cause of action, the court held the plaintiffs had not proven any injury.<sup>197</sup> Although the plaintiffs reported the tax shelter losses on their 2001 tax return, they later filed an amended return eliminating the shelter losses and paid the additional taxes and interest.<sup>198</sup> By voluntarily taking a less risky approach, the plaintiffs were held to be unable to demonstrate that they suffered any injury caused by the defendants.<sup>199</sup> While this type of holding might make sense under appropriate circumstances, it seems incorrect here. Throughout 2001 to 2003 the IRS was vigorously pursuing tax shelter investors. Many of the shelters were determined by the IRS to be illegal, or potentially so, and many were designated as listed transactions. To force a taxpayer to file a tax return claiming invalid losses in order to be able to recover the damages caused by the invalid shelter seems wrong. If anything, by amending their tax return the plaintiffs were reducing their potential damages. Mitigation of damages is a longstanding and almost universal requirement of tort law.<sup>200</sup>

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<sup>191</sup> *Id.*

<sup>192</sup> *Id.* at 51.

<sup>193</sup> 623 F. Supp. 2d 504 (S.D.N.Y. 2009).

<sup>194</sup> *Id.*

<sup>195</sup> *Id.* at 506. There was also an arbitration proceeding, though it is not described in any detail. *Id.* at 509.

<sup>196</sup> *Id.* at 513.

<sup>197</sup> *Id.*

<sup>198</sup> *Id.*

<sup>199</sup> *Id.*

<sup>200</sup> See *Tax Malpractice Damages*, *supra* note 38, at 733–34.

Sound policy would seem to require rewarding the plaintiffs for their conduct limiting potential damages rather than penalizing them.

*Christenbury v. Locke Lord Bissell & Liddell, LLP* raises several fascinating issues, though the case is purely procedural, addressing the production of documents in the face of claims of attorney client privilege.<sup>201</sup> In *Christenbury*, in October 2002 a Texas attorney advised the plaintiff of the Nevis Asset Protection Trust, an insurance-related product offered through Fidelity Insurance Co. Ltd. and another company.<sup>202</sup> The product was recommended in response to the plaintiff's inquiry about obtaining a tax-favorable insurance and financial product.<sup>203</sup> On the plaintiff's behalf, the Texas attorney obtained an opinion from the defendant law firm that the proposed transaction would qualify for an income tax deduction and did not constitute a tax shelter.<sup>204</sup> The opinion was dated December 18, 2002 and was based on a number of factual representations, most of which were supplied by Fidelity.<sup>205</sup> As Fidelity was also a client of the defendant law firm, the defendant obtained a conflict waiver, after it represented that its representation of Fidelity was on unrelated insurance matters.<sup>206</sup> The plaintiff subsequently purchased the financial product from Fidelity.<sup>207</sup>

In September 2003 the plaintiff received a letter from the defendant informing him that certain material facts concerning the product were not as originally represented and that they were retroactively withdrawing their earlier opinion.<sup>208</sup> Upon receiving this letter the plaintiff attempted to terminate his Nevis Trust and recover his \$2.5 million investment.<sup>209</sup> Fidelity offered to refund the investment less a contractually provided redemption or termination fee of \$370,000 and in exchange for an agreement releasing Fidelity from any liability.<sup>210</sup> The plaintiff refused and instituted a suit in the Nevis courts against Fidelity that was still pending at

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<sup>201</sup> 285 F.R.D. 675, 679 (N.D. Ga. 2012).

<sup>202</sup> *Id.* at 678.

<sup>203</sup> *Id.*

<sup>204</sup> *Id.*

<sup>205</sup> *Id.*

<sup>206</sup> *Id.*

<sup>207</sup> *Id.*

<sup>208</sup> *Id.*

<sup>209</sup> *Id.*

<sup>210</sup> *Id.*

the time of trial.<sup>211</sup> The plaintiff sued the Texas attorney, and that suit was resolved pursuant to a confidential agreement.<sup>212</sup>

The plaintiff subsequently instituted this action against the defendant, seeking \$2.5 million in damages.<sup>213</sup> Among the causes of action asserted are breach of contract to perform legal services for the plaintiff, professional negligence in performing the legal work for the plaintiff and negligent misrepresentation in that false information was supplied in the tax opinion and in the conflict waiver.<sup>214</sup> Among the defenses asserted by the defendant is plaintiff's failure to mitigate damages by rejecting Fidelity's redemption offer.<sup>215</sup>

While the substantive issues concerning the effect of the withdrawal of an opinion and mitigation seem most intriguing, the opinion focuses solely on legal privilege and its waiver. The defendant sought to obtain documents relating to the plaintiff's investment decision, including communications with the Texas attorney, and also post-transaction documents relating to tax filings and the plaintiff's decision to reject Fidelity's redemption offer.<sup>216</sup> The court ordered the production of documents related to the plaintiff's decision to invest but not of any post-transaction documents.<sup>217</sup> The plaintiff sought discovery of the defendant's entire client files relating to Fidelity and the other company,<sup>218</sup> but the court denied this.<sup>219</sup>

At present,<sup>220</sup> *Yung v. Grant Thornton LLP* seems to be the only reported generic tax shelter type case that has gone to judgment on the merits.<sup>221</sup> *Yung* is especially significant not just for being the first, but for the magnitude of the total damages awarded (\$100 million),<sup>222</sup> the fact that

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<sup>211</sup> *Id.* at 679.

<sup>212</sup> *Id.*

<sup>213</sup> *Id.*

<sup>214</sup> *Id.*

<sup>215</sup> *Id.*

<sup>216</sup> *Id.*

<sup>217</sup> *Id.* at 686.

<sup>218</sup> *Id.*

<sup>219</sup> *Id.* at 688.

<sup>220</sup> December 2013.

<sup>221</sup> No. 07-CI-2647 (Ky. Cir. Ct. Nov. 8, 2013), available at <http://www.woodllp.com/Publications/Articles/pdf/Yung.pdf>.

<sup>222</sup> *Id.* at 191–92. (The actual damages are a bit below \$100 million since the compensatory damages were only \$19.3 million (\$18.4 million for taxes, interest and penalties and .9 million, return of fee paid for the shelter) rather than \$20 million. For ease of reference they are rounded up to \$20 million.).

punitive damages of \$80 million were awarded as part of the damages, and the egregiousness of the defendant's conduct.<sup>223</sup> The judge found the defendant's conduct to be not only grossly negligent but also fraudulent by both commission and omission.<sup>224</sup>

At a vastly oversimplified level, *Yung* can be summarized as being pretty much a predictable generic tax shelter litigation. Between June, 2000, when first approached by its accounting firm, defendant Grant Thornton, and December 29, 2000, when the first two steps of the shelter transaction were effectuated, the plaintiff Yung<sup>225</sup> was convinced to purchase a tax shelter from the defendant that would enable Yung to repatriate \$30 million from two of his controlled foreign corporations without incurring any income tax.<sup>226</sup> Yung and his advisors were repeatedly assured the plan was legally valid and risk-free and that Grant Thornton would give him its more-likely-than-not opinion to this effect.<sup>227</sup> The first two steps of the transaction were effectuated on December 29, 2000.<sup>228</sup> The third and final step was effectuated on September 28, 2001.<sup>229</sup> Timely tax returns for 2000 and 2001 were filed by Yung after they were either prepared and/or reviewed by Grant Thornton.<sup>230</sup> In 2004 the IRS commenced an audit of the shelter transaction.<sup>231</sup> The audit was settled on June 7, 2007 and resulted in Yung paying additional taxes, interest and substantial penalties.<sup>232</sup> Grant

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<sup>223</sup> *Id.* at 201.

<sup>224</sup> *Id.* at 166–81.

<sup>225</sup> The main focus of the opinion and the defendant's shelter scheme was William Yung. He was a very successful hotelier and entrepreneur who owned many businesses and partnerships. The shelters were actually bought by two of his controlled foreign corporations that were owned by him, his wife and a trust for him and his wife (the "94 Trust"). The ultimate goal of the shelter was to enable Mr. Yung to get a dividend from the two controlled foreign corporations tax free. Many of the contacts and communications between the defendant, Grant Thornton, and Mr. Yung were actually with Mr. Yung's advisors who were technically employed by one of his corporations. *Id.* at 1–4. To simplify the presentation, Mr. Yung will be referred to as the plaintiff and taxpayer. Though its interests are aligned with the plaintiffs, the '94 Trust was designated a defendant. *Id.* at 9. The only real defendant though is Grant Thornton.

<sup>226</sup> *Id.* at 12; see I.R.C. § 61(a)(7) (2012). (Normally, the receipt of a dividend is gross income.).

<sup>227</sup> See, e.g., *Yung*, No. 07-CI-2647 at 28–29.

<sup>228</sup> *Id.* at 57.

<sup>229</sup> *Id.* at 88.

<sup>230</sup> *Id.* at 95, 97.

<sup>231</sup> *Id.* at 101.

<sup>232</sup> *Id.* at 104.



Thornton was involved in the audit. This action was commenced shortly thereafter, on August 29, 2007.<sup>233</sup>

As is suggested by the award of any punitive damages, and certainly by the magnitude of this award, *Yung* involved egregious wrongdoing by the defendant—much more than simply selling a tax shelter that ended up being disallowed. Mr. Yung was very conservative when it came to tax matters.<sup>234</sup> He had previously refused to purchase tax shelters offered to him.<sup>235</sup> He was so meticulous in meeting his tax obligations that he was actually complimented by the IRS for his consistent approach to paying taxes.<sup>236</sup> In addition, Mr. Yung was involved in the gaming industry.<sup>237</sup> The state regulators of the gaming industry take a very dim view of any applicant who participated in a tax shelter.<sup>238</sup> In fact, Mr. Yung's participation in the shelter sold him by the defendant branded him as someone who failed to report income, which later resulted in the inability of one of his corporations to obtain a gaming license, and which in turn resulted in payment of over \$20 million in damages for breach of contract.<sup>239</sup> Due to its longstanding close relationship with Mr. Yung and his entities, the defendant, Grant Thornton, was aware of Mr. Yung's predilections and gaming industry interests.<sup>240</sup>

In *Yung*, the defendant, Grant Thornton, was eager to enter the tax shelter business to meet the competition from the larger accounting firms.<sup>241</sup> But, the firm did not seem to have the required expertise in this area. It was unable to properly analyze the proposed shelter transaction, or to satisfy the technical requirements adequately to attain a high enough confidence level in the product to enable it to give the promised more-likely-than-not opinion that the shelter was valid. During the entire time period from when the shelter was first offered to the plaintiff until well after the plaintiff had purchased and effectuated the shelter, the defendant was still in the process of developing and refining the tax shelter. It was premature of them to sell it to anyone, much less to a very conservative taxpayer who eschewed risky tax products. The early version of the shelter that was sold to the plaintiff

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<sup>233</sup> *Id.* at 183.

<sup>234</sup> *Id.* at 10.

<sup>235</sup> *Id.*

<sup>236</sup> *Id.*

<sup>237</sup> *Id.* at 2.

<sup>238</sup> *Id.* at 154.

<sup>239</sup> *Id.* at 192–94.

<sup>240</sup> *Id.* at 178.

<sup>241</sup> *Id.* at 13.

was actually technically flawed and could never have generated the purported tax benefits, even assuming such tax shelter transactions might be viable.<sup>242</sup> Grant Thornton later revamped the product to eliminate these technical problems, but never informed the plaintiff.<sup>243</sup> In addition, the court found that Grant Thornton had numerous opportunities to inform the plaintiff of the flaws in the shelter while there was still time to take corrective actions that would have obviated the plaintiff's damages.<sup>244</sup> The court held that if informed of the problems with the shelter, the plaintiff would have rescinded or reversed the transaction, filed amended returns, or otherwise ameliorated the situation.<sup>245</sup> Instead, the court found that Grant Thornton never made any of the disclosures it should have because it did not want to lose the \$900,000 fee it received on the sale of the shelter.<sup>246</sup>

Being desperate to complete a sale of its new shelter product, the court found Grant Thornton utilized its position of trust with the plaintiff to convince him and his advisors the product was legal, and not even questionable. The court held the defendant affirmatively and fraudulently misrepresented the product and fraudulently failed to disclose material information in order to effectuate the sale of the shelter.<sup>247</sup> There were also many other instances of unconscionable behavior. Taken together, all of these resulted in the imposition of the large punitive damages award.

Before focusing on the numerous instances of fraud and egregious conduct by the defendant, a brief review of the shelter scheme and the background regulatory environment is helpful to fully appreciate the situation. The shelter was called a Leveraged 301 Distribution or simply a Lev 301.<sup>248</sup> Section 301 of the I.R.C. governs the taxability of dividends received by a shareholder from a corporation, hence the 301 reference. When a dividend is received by a shareholder it is normally included in the shareholder's gross income.<sup>249</sup> The amount of the dividend is the cash received or the fair market value of any property received.<sup>250</sup> If property received is subject to a liability, the amount of the dividend is reduced by

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<sup>242</sup> See *infra* text accompanying notes 355 and 356.

<sup>243</sup> *Yung*, No. 07-CI-2647 at 82–83.

<sup>244</sup> *Id.* at 163.

<sup>245</sup> *Id.* at 181.

<sup>246</sup> *Id.*

<sup>247</sup> See, e.g., *id.* at 168, 177.

<sup>248</sup> *Id.* at 11.

<sup>249</sup> I.R.C. § 301(a) & (c)(1) (2012).

<sup>250</sup> I.R.C. § 301 (b)(1) (2012).

the liability.<sup>251</sup> A constructive or deemed dividend occurs whenever a corporation confers a monetary benefit on a shareholder even if the corporation did not go through the formalities of declaring and paying a dividend.<sup>252</sup>

In the Leveraged 301 transaction, as applied to the plaintiff's situation, his controlled foreign corporations would borrow \$30 million and use the funds to purchase U.S. Treasury Notes.<sup>253</sup> The Treasury Notes would be security for the loan.<sup>254</sup> The corporations would then declare and pay a dividend of the Treasury Notes, subject to the loan.<sup>255</sup> Since the securities and the liability to which they were subject were of equal value, the amount of the dividend would be the net value received, or zero, and not subject to any tax.<sup>256</sup> The plan contemplated that the controlled foreign corporations would wait six months to a year and then pay off the loan, leaving Mr. Yung with \$30 million of tax-free Treasury Notes.<sup>257</sup>

Apart from the potential applicability to this plan of several judicially created anti-tax avoidance doctrines,<sup>258</sup> the product description itself seems to have an internal inconsistency that should have eliminated any prospect for its viability. In arguing that the repayment of the debt by the controlled foreign corporations did not create a constructive or deemed dividend to the shareholders, the description noted that since the controlled foreign corporations were the primary obligors on the debt, they were simply repaying their obligation, and any indirect benefit to their shareholders should not be a constructive dividend.<sup>259</sup> Initially, this argument for the absence of a constructive dividend seems facially incorrect since the payment of the loan by the foreign corporations conferred a monetary benefit on the shareholders by eliminating the debt to which the Treasury Notes were subject. Additionally, the description acknowledged that the

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<sup>251</sup> I.R.C. § 301 (b)(2) (2012).

<sup>252</sup> BORIS I. BITTKER, AND JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, ¶ 8.05[1] (7th ed. 2000) (hereinafter "BITTKER & EUSTICE").

<sup>253</sup> *Yung*, No. 07-CI-2647 at 12.

<sup>254</sup> *Id.*

<sup>255</sup> *Id.* at 11.

<sup>256</sup> *Id.*

<sup>257</sup> *Id.*

<sup>258</sup> The doctrines most relevant are business purpose, economic substance, step transaction, and substance over form. *See generally*, BITTKER & EUSTICE, *supra* note 252, at ¶ 1.05[2][b], [c].

<sup>259</sup> *Yung*, No. 07-CI-2647 at 11.

controlled foreign corporations were the primary obligors on the loan.<sup>260</sup> This in turn would make the initial dividend of the Treasury Notes taxable. As subsequent Treasury Regulations made explicit, if the primary obligor on the debt was expected to, and later did, pay the debt, the Treasury Notes when distributed were not really subject to the debt, so the full value of the Treasury Notes was a taxable dividend.<sup>261</sup> To be even facially viable, the Lev 301 required the original borrowing to be on a nonrecourse basis with no one having personal responsibility for the debt.<sup>262</sup>

When initially contacted in June 2000 by Grant Thornton about investing in the Lev 301 shelter, the climate for investing in such tax shelters was very dangerous.<sup>263</sup> In the early 1990s the government learned of the shelters and addressed them primarily through the IRS's audit function. By 1999 the Treasury and IRS had become more fully aware of the scope and seriousness of the shelter situation. They decided to address the situation by exposing the shelters and the promoters—"sunshine is the best disinfectant." They attacked the shelter problem systemically and systematically. In addition to continuing its audit program, new initiatives and requirements were imposed by regulation and otherwise to curb the spate of tax shelter activities.<sup>264</sup> The active and vigorous crackdown was ultimately successful in shutting down abusive shelters. The defendant was aware of these changes.<sup>265</sup> In *Yung*, the judge took particular note of the following relevant anti-shelter developments:<sup>266</sup>

*December, 1999: The Boss Notice, IRS Notice 99-59.*<sup>267</sup> In this Notice, the IRS described a tax shelter product being sold by accounting firms called The Bond and Option Sales Strategy ("BOSS").<sup>268</sup> After describing the steps of the strategy, the Notice warned that the tax loss claimed in BOSS transactions was not valid and the IRS may impose penalties on participants, promoters and those who report such transactions.<sup>269</sup> Notably, the BOSS transactions also involved a foreign corporation borrowing money to purchase securities, giving the bank a security interest in the

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<sup>260</sup> *Id.*

<sup>261</sup> *Id.* at 59–60.

<sup>262</sup> *Id.* at 14–17.

<sup>263</sup> *Id.* at 15.

<sup>264</sup> *See, e.g.*, the developments mentioned in *id.* at 14–17.

<sup>265</sup> *Id.* at 33–35.

<sup>266</sup> *Id.* at 14–15.

<sup>267</sup> I.R.S. Notice 99–59, 1999–2 C.B. 761.

<sup>268</sup> *Yung*, No. 07-CI-2647 at 14.

<sup>269</sup> *Id.* at 15.

securities, distributing the encumbered securities to a shareholder and the corporation later paying the debt from other assets.<sup>270</sup>

*February 28, 2000:*

1. *Listed Transactions Notice.* Notice 2000-15<sup>271</sup> introduced the term “listed transactions” which were transactions identified in written guidance or regulations by the Treasury as unlawful tax avoidance schemes. This included transactions the same as, or substantially similar to, BOSS transactions.<sup>272</sup>

2. *List Maintenance Requirement.* Regulations were issued requiring any promoter or seller of any interest in a potentially abusive tax shelter to maintain a list of purchasers and to make the list available to the IRS upon request.<sup>273</sup>

3. *Tax Shelter Registration Requirement.* Regulations were issued imposing an obligation on organizers and promoters of certain corporate tax shelters to register them with the Treasury.<sup>274</sup>

4. *Reportable Transaction Obligation.* Regulations were issued requiring corporate taxpayers to disclose on their tax returns any participation in “reportable transactions.”<sup>275</sup> These were transactions the same or substantially similar to listed transactions that were expected to reduce federal income tax liability by more than \$1 million in any year or by more than \$2 million for any combination of taxable years.<sup>276</sup>

*August 11, 2000: Son of BOSS Notice.* Notice 2000-44 addressed a transaction that was a derivative of BOSS and indicated it was not valid.<sup>277</sup> It also indicated that such arrangements were listed transactions and subject to tax shelter registration and list maintenance requirements.<sup>278</sup>

The court also took note of an article published on April 14, 2000 by Lee Sheppard, a “well-known and respected commentator of federal income tax issues.”<sup>279</sup> In the article, under the heading of “Bossy,” she described a

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<sup>270</sup> *Id.* at 14.

<sup>271</sup> Treas. Reg. § 301.6112-1 (2011).

<sup>272</sup> *Yung*, No. 07-CI-2647 at 15.

<sup>273</sup> Treas. Reg. § 301.6112-2 (2003).

<sup>274</sup> Treas. Reg. § 1.6011-4 (2010).

<sup>275</sup> *Yung*, No. 07-CI-2647 at 16.

<sup>276</sup> *Id.*

<sup>277</sup> I.R.S. Notice 2000-44, 2002-2 C.B. 255.

<sup>278</sup> *Id.*

<sup>279</sup> *Yung*, No. 07-CI-2647 at 16. *See also* Lee Sheppard, *Corporate Tax Shelters: More Plain Brown Wrappers*, 87 Tax Notes 321, 322 (Apr. 17, 2000).

variant of the BOSS shelter marketed by Arthur Andersen, but which was very similar to, if not identical with, the Lev 301 product.<sup>280</sup> She predicted the government could combat the shelter by retroactively importing into the section 301 regulations a definition of assumed liability that was added to I.R.C. § 357.<sup>281</sup> This later occurred in January, 2001.<sup>282</sup>

In *Yung*, the court found that the defendant's conduct towards the plaintiff was rife with fraudulent misrepresentations, fraudulent omissions of material information and professional conduct that was grossly negligent.<sup>283</sup> Such conduct occurred both in connection with the sale of the Lev 301 to the plaintiff, the defendant's failure to recognize that the Lev 301 was not legally supportable and on its failure to so advise the plaintiff when the transaction still could be undone or when the tax returns still could be amended.<sup>284</sup>

In *Yung*, the court presented the underlying facts in excruciatingly complete detail. This was likely done for two reasons: first, to support the court's finding of the many instances of unprofessional conduct and fraud which served as the basis for the court's imposition of the large punitive damages award; and second, because of the rather detailed evidence trail available in e-mail records. The following summary of the events is therefore somewhat extended to relay the facts and to illustrate some of the egregious conduct that was the basis for the punitive damages award.

Based on its close relationship with the plaintiff since 1996, and knowing of his careful, conservative approach to complying with the tax laws, the defendant initially approached the plaintiff about engaging a Lev 301 transaction in June, 2000.<sup>285</sup> There were meetings on July 5th and 24th.<sup>286</sup> In both of these meetings the defendant presented the product as a lawful strategy by which to transfer the money from the controlled foreign corporations to the United States.<sup>287</sup> The court found that at the original presentation at the July 5th meeting, the defendant's partners did not disclose that the Lev 301 was similar to the abusive BOSS transaction, that the recently issued February regulations imposed disclosure requirements

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<sup>280</sup> *Yung*, No. 07-CI-2647. at 16–17.

<sup>281</sup> *Id.* at 17.

<sup>282</sup> *Id.* at 59.

<sup>283</sup> *See, e.g., id.* at 168, 177, 181.

<sup>284</sup> *Id.* at 25.

<sup>285</sup> *Id.*

<sup>286</sup> *Id.* at 25, 27.

<sup>287</sup> *Id.* at 26, 28.

on corporations utilizing such transactions, and that sellers were required to maintain a list of participants in such transactions.<sup>288</sup> They also did not inform the plaintiff of the Lee Sheppard article that predicted that a product equivalent to Lev 301 likely would be retroactively declared unlawful.<sup>289</sup> Finally, the court found that the defendant then believed there was a ninety percent chance the IRS would disallow the Lev 301 tax benefits on audit.<sup>290</sup> The court also found that if the likelihood that Lev 301 would be viewed as an unlawful shelter was disclosed at the July 5th meeting, the plaintiff's officers would have immediately terminated discussions about Lev 301.<sup>291</sup>

Mr. Yung was present at the July 24th meeting at which the steps of the transaction were outlined.<sup>292</sup> Based on notes of this meeting, the court found that the defendant never mentioned the requirement that the borrowing of funds from a bank in the first step of the Lev 301 transaction must be nonrecourse.<sup>293</sup> The court further found that while there was mention by the defendant of the need for a non-tax related business purpose for the Lev 301, it was never indicated that this purpose must be the primary motivation for the transaction, and that a clear understanding of this would have had an impact on Mr. Yung's decision whether to proceed with the transaction.<sup>294</sup> At this meeting the defendant's partners also represented that in a worst-case scenario, if the Lev 301 was ineffective, the Grant Thornton opinion would prevent the IRS from assessing any penalties.<sup>295</sup> The court found this representation was a blatant lie made to close the sale and that if Mr. Yung had understood there was a risk of incurring penalties he would not have proceeded with the transaction.<sup>296</sup>

At the July 24th meeting, one of Mr. Yung's advisors told the defendant's partner that Mr. Yung did not want to be the guinea pig by being the first one to do a Lev 301 transaction.<sup>297</sup> At some point following this meeting, the defendant's partner intimated to one of Mr. Yung's advisors that two local, large businesses had successfully utilized Lev 301

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<sup>288</sup> *Id.* at 25.

<sup>289</sup> *Id.*

<sup>290</sup> *Id.*

<sup>291</sup> *Id.* at 26. The court held that the notes of the defendant's partner, J. Michel, were not credible, while the notes of T. Mitchel, one of the plaintiff's representatives were. *Id.* at 28.

<sup>292</sup> *Id.* at 27.

<sup>293</sup> *Id.* at 28.

<sup>294</sup> *Id.* at 28–29.

<sup>295</sup> *Id.* at 29.

<sup>296</sup> *Id.*

<sup>297</sup> *Id.* at 30.

transactions to transfer foreign wealth to the United States.<sup>298</sup> The advisor surmised that these two businesses were General Electric and Proctor & Gamble.<sup>299</sup> The court found this representation was a lie made to complete the sale and that if Mr. Yung had realized that he in fact was the guinea pig for the Lev 301 he would not have engaged in the transaction.<sup>300</sup>

On August 11, 2000 the IRS issued the Son of BOSS Notice<sup>301</sup> and modified certain of the February 28th regulations.<sup>302</sup> These developments caused some of those at Grant Thornton involved with developing and selling the Lev 301 concern about whether Lev 301 remained viable.<sup>303</sup> On August 21st the Wall Street Journal published an article about the BOSS transaction and Price Waterhouse Cooper's decision to stop selling it.<sup>304</sup> In response to this article the defendant stopped selling Lev 301.<sup>305</sup> Also in response to the article, one of Mr. Yung's advisors called the defendant expressing concerns about the legality of Lev 301.<sup>306</sup> He was reassured that there was no cause for concern and that Lev 301 was distinguishable from BOSS transactions.<sup>307</sup> He was not notified, however, that the defendant had stopped selling Lev 301 or that a list maintenance was required.<sup>308</sup>

A final engagement letter was sent by the defendant to the plaintiff around September 15, 2000.<sup>309</sup> Before the letter was finalized, J. Michel, the defendant's primary relationship contact with the plaintiff and his companies, was informed that the defendant could not back up the representation it made that a Grant Thornton opinion would prevent the IRS from assessing penalties in the event there was an audit of the Lev 301 transaction.<sup>310</sup> Instead of dropping the representation, the wording was changed to "soften" what was promised.<sup>311</sup> Mr. Yung was not informed of this since he would not have proceeded with the transaction without this

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<sup>298</sup> *Id.*

<sup>299</sup> *Id.*

<sup>300</sup> *Id.* at 30–31.

<sup>301</sup> I.R.S. Notice 2000-44, 2000-2 C.B. 255.

<sup>302</sup> *Yung*, 07-CI-2647 at 33.

<sup>303</sup> *See, e.g., id.* at 33–35.

<sup>304</sup> *Id.* at 35.

<sup>305</sup> *Id.*

<sup>306</sup> *Id.* at 36.

<sup>307</sup> *Id.*

<sup>308</sup> *Id.* at 37.

<sup>309</sup> *Id.* at 40.

<sup>310</sup> *Id.* at 38.

<sup>311</sup> *Id.*



representation.<sup>312</sup> In addition, although Mr. Michel was advised by his superiors to inform the plaintiff that Grant Thornton would be required to maintain a list of customers to whom it sold Lev 301 shelters, he failed to do so because he knew that this disclosure would kill the sale to Mr. Yung.<sup>313</sup> This failure to disclose was found by the court to be a gross deviation from the standard of care applicable to tax professionals, and this was particularly so in light of Mr. Yung's involvement in the gaming industry.<sup>314</sup> Likewise the engagement letter did not contain any disclosure that Lev 301 was substantially similar to BOSS and was likely to be deemed an abusive tax shelter.<sup>315</sup>

Although Grant Thornton had signed an engagement letter with the plaintiff in mid-September 2000 and had promised a more-likely-than-not opinion letter, they were having internal difficulty concluding Lev 301 was more-likely-than-not valid. Ultimately, they could not attain the more-likely-than-not level of certainty until around the time they issued the final opinions to the plaintiff in August of 2001—and this occurred only after they revised some aspects of the transaction.<sup>316</sup> As part of this ongoing process to satisfy themselves of the legality of the Lev 301 shelter, Grant Thornton engaged the law firm of Baker & McKenzie to review their draft opinion letter.<sup>317</sup> The two Baker & McKenzie tax attorneys who reviewed the opinion had concerns over whether the transaction complied with the judicial doctrines of business purpose, economic substance and step transaction.<sup>318</sup> Neither of the reviewing attorneys was willing to opine that Grant Thornton had reached the more-likely-than-not confidence level it was seeking.<sup>319</sup>

Despite receiving the negative feedback from the law firm, Grant Thornton decided to proceed with the Lev 301 shelter and to attempt to achieve more-likely-than-not status by trying to inject more business purpose into the transaction.<sup>320</sup> The plaintiffs were not informed of the outside legal review nor of the adverse feedback.<sup>321</sup> Rather shockingly, in

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<sup>312</sup> *Id.*

<sup>313</sup> *Id.* at 38–39.

<sup>314</sup> *Id.* at 39.

<sup>315</sup> *Id.* at 41.

<sup>316</sup> *Id.* at 86–87.

<sup>317</sup> *Id.* at 43.

<sup>318</sup> *Id.* at 46.

<sup>319</sup> *Id.*

<sup>320</sup> *Id.* at 47.

<sup>321</sup> *Id.* at 48.

mid-October the defendant's managing partner of tax services informed other partners that a reputable law firm reviewed Lev 301 and gave a "thumbs up."<sup>322</sup> This was an obvious lie to his partners, who passed it on to clients, and it resulted in fraud upon both the clients' and defendant's sales force.<sup>323</sup>

The plaintiff was intending to do the Lev 301 transaction before the end of 2000.<sup>324</sup> Financing had been arranged.<sup>325</sup> Pursuant to the terms of the final engagement letter, before entering into the transaction Grant Thornton had to provide at least its preliminary conclusions that it would be able to issue its promised more-likely-than-not opinion in support of the transaction.<sup>326</sup> Without these assurances the transaction would not occur.<sup>327</sup> The loan was scheduled to close on December 29, 2000.<sup>328</sup> In a letter dated December 28th, Grant Thornton issued a "short-form" or "model" opinion, in order for the transaction to proceed.<sup>329</sup> While not containing all the elements of a complete opinion, it did assert that it was the firm's more-likely-than-not opinion that the transaction would be upheld and that the final opinion letter would contain the same opinion.<sup>330</sup> The letter did not disclose the list maintenance requirement nor the risk stemming from the transaction's similarity to BOSS.<sup>331</sup> The plaintiff was also never informed that the transaction might have to be reported on the tax return, or that Grant Thornton had not yet reached a more-likely-than-not confidence level for the transaction.<sup>332</sup> Relying on this letter, the first two steps of the Lev 301 transaction were completed on December 29th.<sup>333</sup> The \$30 million loan was closed, Treasury Notes were purchased with the proceeds, and

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<sup>322</sup> *Id.* at 50.

<sup>323</sup> *Id.*

<sup>324</sup> *Id.* at 52.

<sup>325</sup> *Id.* at 53. (Several of the defendant's partners had assisted in obtaining the financing and had read, understood and approved the loan documents. They therefore knew or should have known that the loan was recourse as to Mr. Yung's controlled foreign corporations.).

<sup>326</sup> *Id.*

<sup>327</sup> *Id.*

<sup>328</sup> *Id.*

<sup>329</sup> *Id.* at 53–54.

<sup>330</sup> *Id.* at 55–56.

<sup>331</sup> *Id.* at 56.

<sup>332</sup> *Id.* at 56–57.

<sup>333</sup> *Id.* at 57.

dividends of the Treasury Notes subject to the loan were declared and paid.<sup>334</sup>

On January 3, 2001, temporary and proposed regulations were issued under I.R.C. section 301 that invalidated the Lev 301 transaction prospectively and were retroactive for any transactions similar to BOSS shelters described in Notice 99-59.<sup>335</sup> These regulations were essentially what the Lee Sheppard article predicted. The regulations set off internal discussions in Grant Thornton as to whether the Lev 301 was totally dead.<sup>336</sup> On January 8th, Grant Thornton ended sales of Lev 301 until further notice.<sup>337</sup> There was some indication that Grant Thornton directed its personnel to notify all clients of the regulations and that their impact was being evaluated.<sup>338</sup> Despite this, Mr. Yung was not notified nor was he informed that Grant Thornton had ceased marketing Lev 301.<sup>339</sup> The court found that had Mr. Yung been notified he and his advisors would most likely have unwound the December 29th transaction and avoided any negative tax consequences.<sup>340</sup> This would also have prevented Grant Thornton from receiving its \$900,000 fee for the transaction.<sup>341</sup> Quite the contrary, on January 10th, J. Michel e-mailed an employee of the plaintiff and indicated the January 3rd regulations did not adversely affect the plaintiff's transactions since they predated the effective date of the regulations.<sup>342</sup> He also indicated that the regulations might even favorably impact the transaction.<sup>343</sup> This was a lie because at this point in time Grant Thornton had not reached a conclusion on either of these issues.<sup>344</sup> He also failed to disclose that in response to the new regulations Grant Thornton was no longer selling Lev 301.<sup>345</sup>

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<sup>334</sup> *Id.* (The Treasury Notes were not actually remitted to the plaintiff. Instead they remained at the lending bank but were transferred from accounts in the names of the controlled foreign corporations to accounts in the name of the plaintiff.)

<sup>335</sup> I.R.S. Treas. Reg. § 1.301-1 (2001); *Yung*, 07-CI-2647 at 59.

<sup>336</sup> *Yung*, 07-CI-2647 at 64–65.

<sup>337</sup> *Id.* at 65.

<sup>338</sup> *Id.* at 66.

<sup>339</sup> *Id.* at 67.

<sup>340</sup> *Id.* at 68.

<sup>341</sup> *Id.*

<sup>342</sup> *Id.* at 67.

<sup>343</sup> *Id.*

<sup>344</sup> *Id.*

<sup>345</sup> *Id.*

During the ensuing weeks Grant Thornton concluded the new regulations were retroactive to the plaintiff's December 29th transaction, but failed to advise Mr. Yung to unwind the transaction.<sup>346</sup> In response to an inquiry by one of Mr. Yung's employees as to whether the December 29th loans should be paid to stop the interest expense or whether Grant Thornton would pay the interest if the Lev 301 never finalized as planned, on February 6th Grant Thornton sent an incomplete draft of an opinion letter to the plaintiff.<sup>347</sup> On this day Grant Thornton had still not determined if Lev 301 had any ongoing viability.<sup>348</sup> Despite the uncertainty, in April 2001 Grant Thornton decided to start selling the product again.<sup>349</sup> However, it continued to omit crucial details about the products' risks and the weakness of Grant Thornton's legal arguments.<sup>350</sup>

In late May 2001, an attorney unrelated to Grant Thornton reviewed the Lev 301 transaction for one of his clients to whom the Lev 301 was offered.<sup>351</sup> The attorney concluded that Lev 301 did not work under the January 2001 regulations because of the initial loan's recourse nature.<sup>352</sup> Going forward, Grant Thornton modified the Lev 301 to require only nonrecourse borrowing and a representation from the client to this effect.<sup>353</sup> This, of course, meant that the plaintiff's Lev 301 was invalid under the January regulations that applied to it retroactively.

Eventually, on August 8th and 13th, Grant Thornton delivered final opinion letters to the plaintiff.<sup>354</sup> While the ultimate conclusions in the letters were the same as the earlier draft and opined that the Lev 301 was more-likely-than-not valid, the analysis within the letters was changed.<sup>355</sup> More business purpose was inserted, as was the requirement that the initial loan to purchase the securities was nonrecourse.<sup>356</sup> There was also discussion of how the transaction survived under the judicial anti-tax avoidance doctrines.<sup>357</sup> Although the defendant knew the loans obtained by

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<sup>346</sup> *Id.* at 70.

<sup>347</sup> *Id.* at 70–72.

<sup>348</sup> *Id.* at 72–73.

<sup>349</sup> *Id.* at 77.

<sup>350</sup> *Id.*

<sup>351</sup> *Id.* at 81.

<sup>352</sup> *Id.* at 81–82.

<sup>353</sup> *Id.* at 82.

<sup>354</sup> *Id.* at 85.

<sup>355</sup> *See id.* at 85–87.

<sup>356</sup> *Id.* at 87.

<sup>357</sup> *Id.*

Mr. Yung's controlled foreign corporations were recourse, they simply opined that the loans were nonrecourse and treated them as such.<sup>358</sup> Similarly, while they characterized the loans as what one would normally expect when a company finances the distribution of an asset, they knew this to be untrue since they marketed Lev 301 as a tax-avoidance product.<sup>359</sup> The court held that no reasonably competent tax practitioner would have issued this more-likely-than-not opinion for the Lev 301.<sup>360</sup>

Yung's controlled foreign corporations paid off the loans on September 28, 2001, a few days before filing his federal tax forms for 2000.<sup>361</sup> In connection with his 2000 tax forms, it should be noted that on several occasions Grant Thornton had advised that no disclosure of any income from the Lev 301 should appear on the tax returns and insisted on reviewing the forms before they were filed.<sup>362</sup> Despite preparing one of Mr. Yung's tax returns and reviewing another, the defendant did not advise Mr. Yung to report the transactions to minimize or eliminate the risk of penalties.<sup>363</sup> Similarly, in September 2002 Grant Thornton prepared the plaintiff's tax returns for 2001.<sup>364</sup> The returns did not disclose the repayment of the loans by the plaintiff's controlled foreign corporation in September of 2001.<sup>365</sup> This latter decision was especially egregious since Grant Thornton previously had received a request from the IRS in February 2002 requesting it to disclose all of its potentially abusive transactions, and, on June 25, 2002, it was served with a summons requesting all of its list maintenance transactions.<sup>366</sup> The court found that Grant Thornton's intentional failure to report or disclose the Lev 301 "was in furtherance of its efforts to conceal its prior negligent and fraudulent behavior . . ."<sup>367</sup>

Without getting into any of the details, there were a number of instances in 2001 and 2002 when Grant Thornton was either reminded of the invalidity of the Lev 301 sold to the plaintiff,<sup>368</sup> forced to reappraise the

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<sup>358</sup> *Id.* at 94.

<sup>359</sup> *Id.* at 87.

<sup>360</sup> *Id.* at 94.

<sup>361</sup> *Id.* at 88. Grant Thornton only informed the plaintiff of these IRS inquiries when they became public in September 2003. *Id.* at 96.

<sup>362</sup> *Id.* at 25–26, 95–96.

<sup>363</sup> *Id.*

<sup>364</sup> *Id.* at 97.

<sup>365</sup> *Id.*

<sup>366</sup> *Id.* at 97–98.

<sup>367</sup> *Id.* at 97.

<sup>368</sup> *Id.* at 46.

validity of Lev 301 in light of new regulations or new articles in the press,<sup>369</sup> or forced to suspend sales of Lev 301.<sup>370</sup> However, it never informed the plaintiff of any of these—never giving him the opportunity to either attempt to unwind the transaction or to fairly determine how to proceed.<sup>371</sup> Grant Thornton also did not inform the plaintiff that in December of 2002 it received a summons from the IRS specifically for documents relating to Lev 301.<sup>372</sup>

In November of 2002 the IRS initiated an audit of one of plaintiff's corporations, CSC, an S-corporation.<sup>373</sup> The audit was not related to Lev 301.<sup>374</sup> In connection with the audit CSC received a standard Information Document Request ("IDR") inquiring whether CSC had directly or indirectly participated in any transactions that were the same or similar to a listed transaction.<sup>375</sup> Because CSC was an S-corporation, the inquiry effectively asked whether Mr. Yung had individually participated in such a transaction.<sup>376</sup> Mr. Yung's advisors became concerned about whether the Lev 301 should be disclosed since it was similar to BOSS.<sup>377</sup> Mr. Michel of Grant Thornton advised that the transaction was not similar to BOSS, despite the fact the Grant Thornton had previously concluded it was substantially similar.<sup>378</sup> Mr. Michel then responded to the IDR question in the negative.<sup>379</sup> The court concluded this was done to conceal Mr. Yung's involvement in the Lev 301 and to conceal Grant Thornton's prior fraud.<sup>380</sup>

On September 12, 2003 the Department of Justice, on behalf of the IRS, initiated an action to enforce its Lev 301 summons previously served on Grant Thornton.<sup>381</sup> Grant Thornton turned over various documents that identified Mr. Yung as a Lev 301 participant.<sup>382</sup> The CSC audit was subsequently expanded to include audits of Mr. Yung's 2000 and 2001 tax

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<sup>369</sup> *Id.* at 17, 33, 59.

<sup>370</sup> *Id.* at 65.

<sup>371</sup> *Id.* at 48, 56, 67.

<sup>372</sup> *Id.* at 96.

<sup>373</sup> *Id.* at 98.

<sup>374</sup> *Id.*

<sup>375</sup> *Id.*

<sup>376</sup> *Id.*

<sup>377</sup> *Id.*

<sup>378</sup> *Id.*

<sup>379</sup> *Id.*

<sup>380</sup> *Id.* at 98–99.

<sup>381</sup> *Id.* at 99.

<sup>382</sup> *Id.* at 101.

returns.<sup>383</sup> Grant Thornton was involved with the audits, which commenced in May 2004.<sup>384</sup> After an extended process, the audits were settled in 2007, with Mr. Yung paying additional taxes, interest and penalties but with the penalties reduced from twenty percent of the tax initially demanded to thirteen percent.<sup>385</sup>

Before awarding damages the court needed to deal with two threshold issues: a limited liability clause<sup>386</sup> and the statute of limitations.<sup>387</sup> The final engagement letter signed by the parties contained a provision that the maximum liability of the defendant to the plaintiff “arising for any reason relating to the Opinion shall be limited to the amount of fees paid for this engagement.”<sup>388</sup> The fees were \$900,000.<sup>389</sup> In holding that the provision did not limit the defendant’s liability, the court relied on Kentucky precedent that a person cannot contract against fraud.<sup>390</sup> The court then held that the defendant committed fraud, primarily by not informing the plaintiff of the listing requirement.<sup>391</sup> As to contracting against negligence or gross negligence, the court held that in Kentucky such agreements are “generally disfavored and are strictly construed against the parties relying on them.”<sup>392</sup> The court then held that the agreement did not specifically mention negligence or gross negligence and was otherwise not precise enough to cover the type of errors that occurred here.<sup>393</sup> While perhaps morally satisfying in light of the egregious fraudulent conduct of the defendant, this might turn out to be the Achilles heel of the opinion on appeal.

As to statute of limitation concerns, the court held that the statute was tolled until the settlement with the IRS on June 7, 2007 because the defendant was continuously representing the plaintiff in connection with

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<sup>383</sup> *Id.*

<sup>384</sup> *Id.* at 101–02.

<sup>385</sup> *Id.* at 104.

<sup>386</sup> *Id.* at 163–65.

<sup>387</sup> *Id.* at 181–83.

<sup>388</sup> *Id.* at 163.

<sup>389</sup> *Id.*

<sup>390</sup> *Id.* at 164.

<sup>391</sup> *Id.* at 163.

<sup>392</sup> *Id.* at 164 (quoting *Peoples Bank of N. Ky., Inc. v. Crowe Chizek & Co., LLC*, 277 S.W.3d 255, 263 (Ky. Ct. App. 2008)).

<sup>393</sup> *Id.* at 164–65.

Lev 301 matters, and because of the defendant's fraudulent concealment of their misconduct.<sup>394</sup>

The compensatory damages awarded the plaintiff consisted of the additional taxes (\$11,837,860), interest (\$5,021,494) and penalties (\$1,555,873) incurred and a refund of the \$900,000 fee paid for the Lev 301.<sup>395</sup> The court's analysis of these damages was relatively straightforward. The court first noted the law that the measure of damages in a tax malpractice case against an accountant is the difference between what the taxpayer paid and what the taxpayer would have owed absent the negligence.<sup>396</sup> The court found that here absent the negligence, the plaintiff would not have repatriated any money in 2000 and therefore would not have incurred any taxes, interest or penalties.<sup>397</sup> Interestingly, concerning the interest, the court was concerned with whether the underlying amount was adequately liquidated so interest could be awarded under Kentucky law.<sup>398</sup> The court apparently was not aware of the current three approaches to the recovery of interest.<sup>399</sup> Similarly, with respect to the fees paid to the defendant, the court held that but for the defendant's false representations about the Lev 301 product, the plaintiff would never have incurred this fee and was entitled to its return.<sup>400</sup>

The most interesting aspect of the court's damage award was its holding that injury to the plaintiff's reputation as a shareholder and key person in a casino corporation could be considered by the court in its assessment of damages.<sup>401</sup> However, unless this statement is understood to mean that such reputational harm could be considered in awarding punitive damages, the import of this statement is unclear since the court directed a verdict for the defendant regarding such damages.

Late in 2004 one of the plaintiff's corporations acquired a casino for \$60 million in a bankruptcy auction.<sup>402</sup> To complete the acquisition, as sole shareholder of the corporation, Mr. Yung had to obtain a key person license

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<sup>394</sup> *Id.* at 183.

<sup>395</sup> *Id.* at 191–92.

<sup>396</sup> *Id.* at 175 (interestingly the court cited *Lien v. McGladrey & Pullen*, 509 N.W.2d 421, 426 (S.D. 1993), a South Dakota case, for this proposition.).

<sup>397</sup> *Id.*

<sup>398</sup> *Id.* at 176–77.

<sup>399</sup> *See, e.g., supra* text accompanying note 41. *See generally*, Recovery of Interest, *supra*, note 43.

<sup>400</sup> *Yung* 07-CI-2647 at 176.

<sup>401</sup> *Id.* at 192.

<sup>402</sup> *Id.*



from the Missouri Gaming Commission.<sup>403</sup> As part of this process Mr. Yung disclosed the IRS audit of his Lev 301 transaction.<sup>404</sup> In September 2005 he was informed that the Gaming Commission would deny his license primarily because of his participation in the Lev 301 transaction.<sup>405</sup> As a result, he withdrew his license application, fearing that a license denial would adversely impact his other existing casino licenses.<sup>406</sup> The court held that his decision to withdraw the application was commercially reasonable.<sup>407</sup> As a result of withdrawing the license application, he could not complete the purchase of the casino from the bankruptcy auction.<sup>408</sup> The seller of the casino brought a breach of contract suit that was ultimately settled by the payment of \$20.5 million by Mr. Yung's corporation.<sup>409</sup>

The damages of \$20.5 million could not be recovered by Mr. Yung from Grant Thornton since the damages were incurred by Mr. Yung's corporation, not by him personally.<sup>410</sup> However, the court held that Mr. Yung suffered personal reputational damages from this episode.<sup>411</sup>

As noted previously, the court also awarded the plaintiff punitive damages of \$80 million because of the many egregious, fraudulent commissions and omissions by the defendant and because of the many instances of gross negligence of the defendant.<sup>412</sup> The court was very careful to explain the reasons for its award of the damages and to justify their magnitude as roughly four times the compensatory damages.<sup>413</sup>

### *E. Analysis*

In attempting to focus on the potential tax malpractice liability of the attorney and accountant participants in the generic tax shelters, the immediate difficulty that arises is that often the tax professionals were not acting simply in their customary roles as tax advisors but were really the creators and/or purveyors of the shelters. As the two Senate Reports

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<sup>403</sup> *Id.* at 193.

<sup>404</sup> *Id.*

<sup>405</sup> *Id.*

<sup>406</sup> *Id.*

<sup>407</sup> *Id.*

<sup>408</sup> *Id.*

<sup>409</sup> *Id.* at 193.

<sup>410</sup> *Id.* at 194.

<sup>411</sup> *Id.*

<sup>412</sup> *Id.* at 194–209.

<sup>413</sup> *Id.*

indicate, while in form they rendered opinion letters, the tax advisors often were part of the group selling the shelters and their opinion letters were a marketing tool to make the product appear efficacious and to make the sale.<sup>414</sup> As such, the automatic reaction is that they ought to be responsible under some actual or implied warranty as sellers or under principles of fraud, deceit, misrepresentation or the like. It seems very difficult, if not impossible, to disentangle their roles as principals from their roles as tax advisors and focus only on the latter.

To attempt to separate out the tax malpractice issues from the other issues lurking in the generic tax shelter scenario, let us assume a potential purchaser of a tax shelter consults with an independent attorney or accountant concerning the viability of the shelter. The tax advisor ultimately determines the shelter is viable and renders an opinion letter that the transaction is more-likely-than-not viable and valid. The client then purchases the shelter, faithfully effectuates all the steps prescribed by the shelter, and claims the deductions on the tax return. It later turns out the shelter is ineffective and the client incurs back taxes, interest, penalties and corrective costs.

The initial issue would seem to be that the tax advice given that the tax shelter was efficacious was wrong and that, perhaps, liability should be imposed on the tax professional for this reason alone. However, under the error in judgment rule, being wrong does not automatically subject a tax professional to liability.

[Professionals are not infallible] and the law does not impose on them an implied guaranty of result. As long as their opinion is based on adequate research and careful consideration of the matter, the fact that their judgment on a doubtful or unsettled area of law turns out to be incorrect will not give rise to malpractice liability.<sup>415</sup>

As I stated previously, based upon the leading treatise on attorney malpractice:

Professionals, especially attorneys, are frequently called on to exercise judgment to resolve issues that are uncertain and subject to disagreement. To subject an attorney to malpractice liability simply because a judge ultimately

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<sup>414</sup>S. Rep. No. 108-34, at 5 (2003); *see, e.g., supra* text accompanying footnotes 91–103; *see* S. Rep. No. 109-54, at 5 (2005).

<sup>415</sup>WOLFMAN ET AL., *supra* note 20, at § 603.5.

disagrees with a judgment call would be unfair and place too great a burden on the legal profession. Because of those concerns, under the mere error in judgment rule it is universally recognized that an attorney is not liable for an error of judgment on an unsettled proposition of law.<sup>416</sup>

A caveat is necessary at this point to differentiate between attorney and accountant tax advisors. While it is clear that the error in judgment rule applies to attorneys and its application is said to be universal, the application of this rule to accountants is more problematic.<sup>417</sup> The source of the problem is that I am unable to locate any case law that applies the rule to accountants. Several leading commentators do equate accountants and lawyers and indicate the error in judgment rule applies to both professions.<sup>418</sup> The logic underlying the rule would seem to apply equally to both—at least where the accountant is functioning as a tax advisor—and there are cases that hold the elements of a tax malpractice action are substantially identical regardless of whether the defendant is an accountant or attorney.<sup>419</sup> Nevertheless, the absence of case law applying the rule to accountants is of concern.

Another reason why liability might not be imposed on the tax professional, though the advice was incorrect, is inherent in the type of opinion rendered. The opinion posited in our example is the type of opinion normally encountered in the tax shelter area, the “more-likely-than-not” opinion. This opinion asserts only that the professional rendering it believes there is a greater than fifty percent likelihood that the transaction under review will be held to be valid.<sup>420</sup> The more certain opinions that a

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<sup>416</sup>Todres, *supra* note 104, at 222.

<sup>417</sup>2 MALLIN AND SMITH, *supra* note 28 § 19:1.

<sup>418</sup>WOLFMAN ET AL., *supra* note 20, § 603.5.

<sup>419</sup>*See, e.g.*, Hnath v. Vecchitto, No. X03CV930502910, 2003 Conn. Super. LEXIS 1063, at \*22 (Conn. Super. Ct. Feb. 20, 2003); Gantt v. Boone, Wellford, Clark, Langschmidt & Pemberton, 559 F. Supp. 1219, 1227 (M.D. La. 1983), *aff'd*, 742 F.2d 1451 (5th Cir. 1984); Bancroft v. Indem. Ins. Co. of N. Am., 203 F. Supp. 49, 53 (W.D. La. 1962), *aff'd*, 309 F.2d 959 (5th Cir. 1962); Jewish Hosp. of St. Louis, MO v. Boatman’s Nat’l Bank of Belleville, 633 N.E.2d 1267, 1278 (Ill. App. Ct. 1994); Jerry Clark Equip., Inc. v. Hibbits, 612 N.E.2d 858, 863 (Ill. App. Ct. 1993); Vernon J. Rockler & Co., Inc. v. Glickman, Isenberg, Lurie & Co., 273 N.W.2d 647, 650 (Minn. 1978).

<sup>420</sup>*See, e.g.*, LINDA GALLER & MICHAEL B. LANG, REGULATION OF TAX PRACTICE, 100 (Matthew Bender & Co. 2010). The opinions in both *Loftin* and *Seippel* were “more-likely-than-not” opinions. *Loftin v. KPMG LLP*, No. 02-81166-CIV-RYSKAMP/VITUNAC, 2002 U.S. Dist. LEXIS 26909, at \*7 (S.D. Fla. Sept 10, 2003); *Seippel v. Jenkins & Gilchrist, P.C.*, 341 F. Supp. 2d 363, 379 (S.D.N.Y. 2004).

transaction “should” or “will” be valid are never encountered.<sup>421</sup> Exactly how much reliance is a layman entitled to place on an opinion that is so weak? A fair translation of this opinion is that in 100 transactions of this type, 51 will be held to be valid and 49 will be held to be invalid. This certainly seems to be very little reassurance of validity and a weak basis for imposing liability.

Militating the other way, though, is the fact that if the transaction really has no chance for success, or only a very minimal chance for success, the opinion has still vastly overstated the likelihood for success and perhaps “caused” the plaintiff damages that ought to be recoverable. In any event, in many of the reported generic tax shelter cases there were oral representations that indicated a much higher probability of validity for the transaction. The oral representations might serve as an independent basis for recovery, apart from the written opinion.

While not an issue in the posited hypothetical example, a factor possibly undercutting the utility of the tax advisor’s opinion as a basis for liability in most of the reported generic tax shelter cases is the fact that those opinions were normally given after the transactions had already been effectuated.<sup>422</sup> As such, they were opining on something that had already occurred. It would be a stretch to argue that they “caused” the taxpayer to purchase the shelter. If anything, it seems that the cause, or, at least, one of the several causes, of the damages for purchasing the shelter would rather be *the promise* that an opinion letter would be forthcoming, (or a short form or draft of the opinion letter to come). This, of course, makes it more difficult for a plaintiff to establish the cause of action, since there is no written documentary evidence to establish what was promised to induce the shelter purchase. Now, what was said also needs to be proven, and there is a great likelihood that each side of the conversation would remember it differently.

In addition to the tax malpractice issues relative to the issuance of the incorrect opinion that the proposed shelter transaction was valid, there are

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<sup>421</sup>The “should” opinion expresses a stronger likelihood of success than the “more-likely-than-not” opinion and is generally considered to mean a probability of success of more than seventy percent. GALLER & LANG, *supra* note 420, at 100. The “will” opinion is the strongest opinion, suggesting a probability of success of between 95 and 100 percent. *Id.* at 101.

<sup>422</sup>*See, e.g., Loftin*, 2002 U.S. Dist. LEXIS 26909 at \*6–7 (transactions occurred in September to December, 1997, opinions were received in June, 1998); *Seippel*, 341 F. Supp. 2d at 369. (transactions occurred in late 1999, opinions were received in February and March, 2000). Was this done to protect the attorney from potential malpractice exposure or, perhaps, to enable the opinion to be based on the facts as they occurred rather than on how they were projected to occur?

also tax malpractice issues concerning the tax return preparer who reported the tax shelter deductions on the tax return. To avoid underpayment penalties, there must be a reasonable basis for claiming deductions or losses on the tax return.<sup>423</sup> If the shelter deductions were not reported on the tax return, there would not have been any subsequent interest, penalty, or corrective cost damages from underreporting the taxpayer's tax liability. Thus, the return preparer may face potential liability for causing some, or all, of the taxpayer's damages. Very relevant to the return preparer's potential liability in this regard is the existence, and the return preparer's knowledge, of any opinions that opined that the shelter was valid. These opinions, especially one from a source independent of the seller of the shelter might, itself, be enough to exonerate the return preparer from any liability.

Although perhaps very obvious, it should be noted that if the particular tax shelter involved was a listed transaction, or was otherwise designated as an abusive shelter that must be reported on the tax return, the return preparer must be aware of the requirement and comply with it. Any failure may lead to malpractice liability exposure.

Although not directly relevant as a technical matter, a prediction of who is likely to be successful in a tax malpractice litigation often depends on the intangible of which side is more sympathy evoking, or stated more colloquially, who is the good guy and who is the bad guy. By this measure, both parties seem to have problems, though, ultimately, the plaintiff taxpayer seems to be somewhat better than the defendant tax advisor. The plaintiff taxpayer in these situations does not evoke much sympathy. Ultimately, she or he is a very rich person who received a great deal of money and who attempted to avoid paying her or his fair share of taxes due by spending a lot of money on some high-cost, esoteric tax gimmick promising results too good to be true that an average taxpayer could not even imagine. In short, she or he is a really rich, selfish, tax avoider, at best, or tax evader, at worst.

The defendant tax advisor is not much better. Even if we address only the type of advisor posited herein *i.e.*, one who is honest and straightforward and who is not engaging in the fraudulent and deceitful conduct often present in the reported generic tax shelter situations, the advisor still does not fare too well. After all, the tax advisor is a fancy professional who studies tax esoteric and who develops, or opines upon, the type of schemes that enable the very rich, like the plaintiff, to avoid paying

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<sup>423</sup> See I.R.C. §§ 6662, 6664 (2012).

millions of dollars of taxes. At best, she or he charges outrageous fees to facilitate and enable the opprobrious conduct of people like the plaintiff. And, to make it worse, the advice given was wrong! *A fortiori* where the tax advisor is more like the typical advisor highlighted in the Senate Reports, who was either the seller of, or one of the group selling, the shelter.

While both sides have likeability problems, I believe the plaintiff shelter investor comes off a little better than the tax advisor. Here, once the plaintiff concedes she or he is wealthy and was trying to avoid paying taxes, the argument presented is that they were trying to avoid paying taxes in a legally permissible and lawful manner. As such they did everything appropriately. They consulted with a tax professional who appeared to be respected and knowledgeable. They did exactly what the tax professional advised, and they proceeded only because they were advised they could legally do so. What else is a layman supposed to do when dealing with a very intricate and labyrinthine statute such as the tax law?

### III. OTHER TAX MALPRACTICE DEVELOPMENTS

#### A. Preliminary

##### 1. Scope of Engagement

The basic relationship between a client and an attorney, accountant or other professional is defined by the scope of engagement. Why was the attorney or other professional hired? Accordingly, before issues of malpractice may be addressed, it is necessary to ascertain the scope of the engagement. Ideally, the nature of the representation should be specified in writing and in enough detail so that there is no room for any misunderstanding between the parties. *180 E. 88th St. Apt. Corp. v. Law Office of Robert Jay Gumenick, P.C.* illustrates the benefit of doing it right.<sup>424</sup> In this case the plaintiff was a housing cooperative corporation and the defendant was the law firm retained to draft the contract of sale for the plaintiff's building.<sup>425</sup> This litigation involved the claim by the plaintiff that the defendant "failed to structure the contract of sale with tax implications considered, or to have at least advised them to look into the tax issues

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<sup>424</sup>923 N.Y.S. 2d 474 (N.Y. App. Div. 2011).

<sup>425</sup>*Id.* at 475.

underlying the sale.”<sup>426</sup> Because the underlying retainer agreement provided that the defendant would not provide tax advice in connection with the transaction but would be available to discuss such issue with plaintiff’s tax advisor or accountant, the First Department had no problem affirming the lower court’s dismissal of the complaint on a motion for summary judgment.<sup>427</sup> The defendant attorney therefore was able to expeditiously end the litigation.

The danger of not having a written agreement specifying the scope of engagement is illustrated by *Wo Yee Hing Realty Corp. v. Stern*.<sup>428</sup> *Wo Yee* also involves a suit between the seller of a building and the seller’s attorney concerning a missed tax opportunity upon the sale of the building.<sup>429</sup> Here, the defendant attorney testified that at the inception of the representation and on a number of subsequent occasions he informed the plaintiff’s officer that he had no expertise or experience with structuring a section 1031 like-kind exchange and that the responsibility for doing so would remain with the officer.<sup>430</sup> The defendant further testified that the officer stated that he would take care of the section 1031 part of the transaction and that he had done these in the past.<sup>431</sup> This agreement, however, was never reflected in writing.<sup>432</sup> The plaintiff’s officer testified to the contrary—that the defendant had agreed to take care of the section 1031 exchange requirements and that the officer was unfamiliar with how a section 1031 exchange worked.<sup>433</sup> The stakes were quite high, since \$5.1 million of additional taxes were alleged to have been incurred due to the unavailability of a section 1031 exchange.<sup>434</sup>

Here, unlike in *180 E. 88th St.*,<sup>435</sup> there was no written retainer agreement or other written evidence to establish who had agreed to be

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<sup>426</sup> *Id.* The precise nature of the tax benefit lost is not clearly specified. The court later refers to an argument by plaintiff that defendant caused it to suffer “a capital gains tax loss.” *Id.* at 475-76. Perhaps the loss of capital gains tax rates is involved.

<sup>427</sup> *Id.* at 475-76.

<sup>428</sup> No. 115517/07, 2011 WL 892757 (Sup. Ct. N.Y. Cty. Feb. 10, 2011), *aff’d*, 949 N.Y.S.2d 50 (N.Y. App. Div. 2012).

<sup>429</sup> *Id.* at \*1.

<sup>430</sup> *Id.*

<sup>431</sup> *Id.*

<sup>432</sup> *Id.*

<sup>433</sup> *Id.* at \*2, \*3.

<sup>434</sup> *Id.* \*3. See *infra* part III. E.3. on page 2.

<sup>435</sup> *180 E. 88th St. Apt. Corp. v. Law Office of Robert Jay Gumenick, P.C.*, 923 N.Y.S. 2d 474 (N.Y. App. Div. 2011); *supra* text accompanying note 424-427.

responsible for meeting the section 1031 exchange requirements.<sup>436</sup> Even if the defendant attorney was correct and the plaintiff's officer had agreed to be responsible, a relatively expeditious disposition of the suit by a motion to dismiss was unavailable.<sup>437</sup> The defendant attorney, however, was successful in obtaining summary judgment dismissing the case, but because of a substantive defect in the plaintiff's cause of action—the plaintiff failed to prove that the defendant's negligence proximately caused the plaintiff's damages.<sup>438</sup>

In *Wo Yee*, at the closing of the sale of the old property, the plaintiff actually received the sales proceeds, making section 1031 treatment unavailable.<sup>439</sup> The court, however, held the plaintiff never offered any satisfactory proof that it met all of the other requirements for a section 1031 exchange.<sup>440</sup> The type of section 1031 exchange possibly applicable in *Wo Yee* required evidence establishing that the plaintiff could have identified the replacement property within 45 days of the sale of the old property and would have actually received it within 180 days of the closing of the sale of the old property.<sup>441</sup> Accordingly, the court held that even if, *arguendo*, the defendant attorney was negligent in allowing the plaintiff to obtain the sales proceeds for the old property, there was no proximate causation of damages to the plaintiff, since the other requirements for section 1031 treatment were not present.<sup>442</sup> The plaintiffs never proved that but for the defendant's malpractice, section 1031 treatment would have been available.<sup>443</sup>

In *Ambase Corp. v. Davis Polk & Wardwell*, the plaintiff corporation became an independent entity in 1985 upon the liquidation of its parent company.<sup>444</sup> As part of the liquidation, the plaintiff agreed to assume primary liability for its parent's federal income taxes and secondary liability for certain other liabilities of its parent.<sup>445</sup> Shortly thereafter, the IRS determined that the parent failed to withhold taxes on the payment of

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<sup>436</sup> See 2011 WL 892757, at \*1.

<sup>437</sup> See generally *id.*

<sup>438</sup> *Id.* at \*4–5.

<sup>439</sup> *Id.* at \*2.

<sup>440</sup> *Id.* at \*5.

<sup>441</sup> *Id.* at \*4.

<sup>442</sup> *Id.* at \*3, \*5.

<sup>443</sup> *Id.* at \*5.

<sup>444</sup> 866 N.E.2d 1033, 1035 (N.Y. 2007).

<sup>445</sup> *Id.*



interest to a related foreign entity from 1979 through 1985.<sup>446</sup> Attempts to settle the matter failed, and in 1992 the defendant law firm was retained to settle the tax matter.<sup>447</sup> In May, 1995 the IRS issued a notice of deficiency for almost \$21 million for the withholding taxes alleged to be due.<sup>448</sup> Defendant, Davis Polk, then successfully litigated the matter in tax court and won a complete victory in 2001.<sup>449</sup> Following the victory, the plaintiff refused to pay the outstanding legal fees of over \$1.4 million.<sup>450</sup> Plaintiff then commenced this action against Davis Polk for legal malpractice, alleging that Davis Polk failed to advise the plaintiff that it was only secondarily liable for the payment of the withholding taxes.<sup>451</sup> The plaintiff also requested a declaration that it did not owe the legal fees.<sup>452</sup> The damages claimed, apart from the legal fees, are very interesting and novel.<sup>453</sup> Plaintiff claimed that but for Davis Polk's negligence, it would not have had to maintain a large loss reserve on its books, which created the appearance that it had a negative net worth, which in turn caused it to lose business opportunities.<sup>454</sup>

The trial court granted Davis Polk's motion to dismiss the complaint and awarded it a money judgment for the unpaid legal fees.<sup>455</sup> The Appellate Division affirmed.<sup>456</sup> The Court of Appeals also affirmed the trial court's decision primarily because the retainer agreement provided that Davis Polk was retained to litigate the amount of tax liability.<sup>457</sup> It was never required to address the issue of whether the plaintiff was primarily or secondarily liable.<sup>458</sup> The court also noted some factual problems with the plaintiff's cause of action, such as that the plaintiff had privately and

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<sup>446</sup> *Id.* Under I.R.C. § 881(a)(1), a withholding tax of thirty percent is imposed on the payment of interest to a foreign corporation. I.R.C. § 881(a)(1) (2012).

<sup>447</sup> *Ambase Corp.*, 866 N.E.2d at 1035.

<sup>448</sup> *Id.*

<sup>449</sup> *Id.*

<sup>450</sup> *Id.*

<sup>451</sup> *Id.*

<sup>452</sup> *Id.*

<sup>453</sup> *See id.* at 1036.

<sup>454</sup> *Id.*

<sup>455</sup> *Id.* at 1035–36. A secondary issue was also involved as to whether the monetary award of legal fees to the defendant was proper since it never explicitly demanded, nor counterclaimed for this amount. *Id.* at 1034–35. This award was also upheld by the Court of Appeals. *Id.* at 1038.

<sup>456</sup> *Id.* at 1036.

<sup>457</sup> *Id.* at 1037–38.

<sup>458</sup> *Id.* at 1037.

publicly acknowledged that it was responsible for the subject taxes approximately seven years before Davis Polk was retained.<sup>459</sup> Also, the plaintiff and its accountants had decided to maintain the loss reserve on its books despite the fact that Davis Polk advised them, soon after it was initially retained, that in its attorneys' opinion the plaintiff had a very strong case and was probably not liable for the taxes.<sup>460</sup>

An interesting aspect of the Court of Appeals' opinion is that it went out of its way to reaffirm New York's judgmental immunity rule.<sup>461</sup> Although not necessary for its holding, the court noted that the retainer agreement between the parties was never construed by any court or arbitrator as to the issue of whether the plaintiff undertook primary liability for the withholding taxes involved in this litigation.<sup>462</sup> The court then quoted its earlier observation that "[a] legal malpractice action is unlikely to succeed when the attorney erred because an issue of law was unsettled or debatable."<sup>463</sup>

*Cohen v. Weitzner* is somewhat similar to *Ambase*, since here too the defendant attorney was hired for one task but liability for another issue was sought to be imposed.<sup>464</sup> It also illustrates the need to avoid mundane, non-legal errors.<sup>465</sup> In *Cohen*, the plaintiffs had filed their 1997 through 2002 income tax returns in 2003.<sup>466</sup> The IRS accepted the tax liability as reported on the returns but also assessed penalties for late filing and late payment and interest.<sup>467</sup> The defendant attorney was retained to seek an abatement of the penalties due to the plaintiff husband's medical condition.<sup>468</sup> The defendant was successful, reaching an agreement with the IRS to abate all penalties for 1997 and 1998 and for plaintiffs to have one year to pay the remaining amounts due.<sup>469</sup> The problem asserted by the plaintiff was that there was a typographical error on one of the spreadsheets prepared by the

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<sup>459</sup> *Id.*

<sup>460</sup> *Id.*

<sup>461</sup> *See id.*

<sup>462</sup> *Id.*

<sup>463</sup> *Id.* (quoting *Darby & Darby, P.C. v. VSI Int'l, Inc.*, 739 N.E.2d 744, 748 (N.Y. 2000)).

<sup>464</sup> 850 N.Y.S.2d 410, 411 (N.Y. App. Div. 2008).

<sup>465</sup> *See id.*

<sup>466</sup> *Id.*

<sup>467</sup> *Id.*

<sup>468</sup> *Id.*

<sup>469</sup> *Id.*

defendant that understated their tax for 2000 and that they were damaged in this amount.<sup>470</sup>

The claim asserted seems frivolous since the basic tax liability was never an issue in the representation, and the plaintiffs failed to allege how they were damaged.<sup>471</sup> The First Department affirmed the trial court's dismissal of the complaint.<sup>472</sup>

In *Offshore Express, Inc. v. Milbank, Tweed, Hadley & McCloy, LLP*, the defendant attorneys had represented the owner of the plaintiff in a 1998 reorganization transaction in which an existing corporation was split into two corporations, one of which was the plaintiff.<sup>473</sup> As part of that transaction a tax-sharing agreement was also signed.<sup>474</sup> Subsequently, disputes arose over the allocation of the old corporation's income taxes for 1997 and 1998.<sup>475</sup> These disputes ended in arbitrations in which the defendant represented the plaintiff.<sup>476</sup> The plaintiff lost the arbitrations and subsequently brought this action one day short of the three-year limitations period.<sup>477</sup>

In this litigation the defendant moved for summary judgment to dismiss the malpractice claims arising from the reorganization transaction as barred by the statute of limitations.<sup>478</sup> While the parties had executed an engagement letter for the reorganization representation, no agreement was signed concerning representation at the arbitrations.<sup>479</sup> The issue before the court was whether the reorganization and the arbitrations were one continuous matter or two distinct matters for statute of limitations purposes.<sup>480</sup> The court held they were two matters and that the statute of limitations had expired vis-à-vis the reorganization transaction.<sup>481</sup> While ultimately successful, the existence of a separate engagement letter for the

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<sup>470</sup> *Id.*

<sup>471</sup> *Id.*

<sup>472</sup> *Id.*

<sup>473</sup> No. 03 Civ. 4260(PAC), 2007 WL 760419, at \*1 (S.D.N.Y. Mar. 13, 2007).

<sup>474</sup> *Id.*

<sup>475</sup> *Id.* at \*2.

<sup>476</sup> *Id.*

<sup>477</sup> *Id.*

<sup>478</sup> *Id.* at \*1.

<sup>479</sup> *Id.* at \*1–2.

<sup>480</sup> *Id.* at \*1.

<sup>481</sup> *Id.* at \*4.

arbitrations likely would have been helpful in disposing of the claim more expeditiously.<sup>482</sup>

*In re Mirabilis Ventures, Inc. v. Saxon, Gilmore, Carraway, Gibbons, Lash & Wilcox, P.A.* is really an unusual case to be included in this section of the article, but its ultimate resolution really comes down to a scope of engagement analysis.<sup>483</sup> In *Mirabilis*, the person who controlled the plaintiff, Frank Amodeo, used the plaintiff and “a web of subsidiaries and related companies as vehicles for an enormous tax fraud and money laundering scheme.”<sup>484</sup> Essentially, companies were established to provide human resources services to various clients.<sup>485</sup> These companies would calculate the payroll taxes owed by the clients and collect the amounts from them.<sup>486</sup> However, these taxes were never paid to the IRS, but were diverted to Amodeo’s and his co-conspirators’ personal uses.<sup>487</sup> Amodeo eventually pled guilty to a number of felonies and was sentenced to over twenty-two years in jail and ordered to pay restitution of over \$181 million.<sup>488</sup> Plaintiff was also under criminal indictment and had agreed to plead *nolo contendere*.<sup>489</sup> This suit was instituted against the defendant attorney and his law firm seeking damages for various negligence and related claims.<sup>490</sup> The court characterized all of plaintiff’s claims as boiling down to an allegation that the defendant attorney “either advised the people running *Mirabilis* that diverting payroll tax funds to other uses was acceptable, or at least learned of the plans to do so and failed to warn anyone.”<sup>491</sup> The only problem was that the defendant attorney was employed by an affiliate of *Mirabilis* in a capacity not involving legal advice regarding tax matters.<sup>492</sup> The defendant testified that the first time he heard about plans to divert payroll taxes was when he was sued in this case.<sup>493</sup> Not having any evidence connecting the defendant with the fraud, the court granted defendant’s motion for summary

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<sup>482</sup> *See id.* at \*2, \*4.

<sup>483</sup> *See* No. 6:09-cv-1974-Orl-31DAB, 2010 WL 2509624, at \*5 (M.D. Fla. June 18, 2010).

<sup>484</sup> *Id.* at \*1.

<sup>485</sup> *Id.*

<sup>486</sup> *Id.*

<sup>487</sup> *Id.*

<sup>488</sup> *Id.*

<sup>489</sup> *Id.*

<sup>490</sup> *Id.*

<sup>491</sup> *Id.* at \*2.

<sup>492</sup> *Id.* at \*3.

<sup>493</sup> *Id.*

judgment.<sup>494</sup> Again, establishing the defendant attorney's scope of engagement was key to vindicating him—and doing so by summary judgment.<sup>495</sup>

A variation of the scope of engagement issue arises in connection with tax return preparation. As such it will normally pertain to accountants, but can also affect other professionals. The issue can be placed in focus by the question, “whose tax return is it?” If the taxpayer gives the return preparer an amount of charitable contributions, medical expenses, or some other deduction, then who is responsible for the accuracy of this number? The simple answer is the taxpayer. *Freeman v. Usoroh* hit the nail on the head:

By signing her tax return, plaintiff acknowledged the veracity of its contents and became responsible for providing proof of the items deducted upon request of the IRS. Even had defendant tax preparer been negligent in his advice to plaintiff, he cannot be held responsible for plaintiff's inability to provide proof of her entitlement to the refund . . . .<sup>496</sup>

In *Freeman*, the court reversed damages awarded the plaintiff in a small claims proceeding on the reasoning stated above.<sup>497</sup> It is the taxpayer's return, and the preparer is not responsible for the taxpayer's inability to prove amounts claimed on the return.<sup>498</sup>

Although not involving allegations of negligence or malpractice, the underlying situation in *Wooley v. Jackson Hewitt, Inc.* is a most informative counterpoint to the simple principle presented in *Freeman* that it is the taxpayer's tax return.<sup>499</sup> In *Wooley*, the plaintiff taxpayer alleged that the Jackson Hewitt franchise office that prepared his tax return simply made up false charitable and other deductions on his tax return that he did not authorize.<sup>500</sup> Relying on defendant's purported competency and accuracy, the plaintiff simply signed and filed the return.<sup>501</sup> These deductions were disallowed upon audit and additional taxes, penalties, and interest were

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<sup>494</sup> *Id.* at \*6.

<sup>495</sup> *See id.* at \*5.

<sup>496</sup> No. 570586/04, 2005 WL 1704439, at \*1 (N.Y. App. Term July 20, 2005).

<sup>497</sup> *Id.*

<sup>498</sup> *Id.*

<sup>499</sup> *See* 540 F. Supp. 2d 964, 980 n.4 (N.D. Ill. 2008).

<sup>500</sup> *Id.* at 968.

<sup>501</sup> *Id.*

incurred.<sup>502</sup> The dispute between the plaintiff and Jackson Hewitt arose when Jackson Hewitt refused to honor either its basic guarantee that it would pay any penalty or interest incurred as a result of any error by Jackson Hewitt or its Gold Guarantee, for which the plaintiff paid extra, that Jackson Hewitt would pay additional taxes up to \$5,000 if caused by their error.<sup>503</sup> Since the same scenario occurred to two of plaintiff's postal co-workers, this suit was brought as a class action.<sup>504</sup>

Ultimately *Wooley* became a simple breach of contract case as to whether Jackson Hewitt was justified in not fulfilling its basic guarantee.<sup>505</sup> One of Jackson Hewitt's arguments was that the plaintiff was not entitled to reimbursement under its basic warranty because if the plaintiff would have properly reviewed his income tax return he would have discovered the unauthorized deductions.<sup>506</sup> In response, the court noted that although a taxpayer is legally responsible for his return and cannot escape liability by blaming the return preparer, this does not prevent the taxpayer from asserting a breach of contract claim against the preparer for an erroneous or inaccurate return.<sup>507</sup>

In *Daunno v. Crincoli*, the plaintiff's husband failed to file federal and New Jersey income tax returns for the couple from 1991 through 1996.<sup>508</sup> After receiving summonses from the IRS and New Jersey in 1997, the defendant CPA was retained by the plaintiff's husband to file the delinquent returns.<sup>509</sup> Consistent with their practice that plaintiff's husband handled all of the couple's tax and financial matters, only he met and spoke with the defendant.<sup>510</sup> The husband gave the defendant all necessary financial information to complete the tax returns.<sup>511</sup> Also, the husband informed the defendant that the marital house was jointly owned, though it was actually owned solely by the plaintiff.<sup>512</sup> Based on the data supplied, the defendant determined that the husband would save about \$55,000 if he and the

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<sup>502</sup> *Id.*

<sup>503</sup> *Id.* at 968, 971.

<sup>504</sup> *Id.* at 967, 969.

<sup>505</sup> *Id.* at 971.

<sup>506</sup> *Id.* at 980.

<sup>507</sup> *Id.* at 980 n.4.

<sup>508</sup> 2007 WL 135889, at \*1 (N.J. Super. Ct. App. Div. Jan. 22, 2007).

<sup>509</sup> *Id.*

<sup>510</sup> *Id.*

<sup>511</sup> *Id.*

<sup>512</sup> *Id.*

plaintiff filed jointly rather than separately.<sup>513</sup> The plaintiff had little or no income during this time period, and, if filing separately, would have had to file only for 1995 with income of less than \$10,000.<sup>514</sup>

When asked by the defendant about how he would pay the delinquent taxes of approximately \$270,000, the plaintiff's husband responded that he was to obtain a large inheritance soon, that he expected to imminently settle several large cases in his law practice, and that the marital home could be refinanced.<sup>515</sup> Pursuant to instructions from the plaintiff's husband, the defendant prepared joint returns, which were duly signed by the plaintiff and her husband and filed.<sup>516</sup> Despite the receipt of the inheritance and the sale of plaintiff's husband's successful law practice, the taxes were never paid.<sup>517</sup>

In 2001 when the plaintiff's husband became ill, the plaintiff first learned of her tax problems when she tried to sell the marital home and learned that there was about \$900,000 in tax liens on the house.<sup>518</sup> The plaintiff subsequently filed in bankruptcy and retained only a small portion of the home's equity.<sup>519</sup> She also incurred about \$57,000 in legal fees.<sup>520</sup> The plaintiff then instituted this malpractice action against the defendant accountant and his accounting firm, asserting that he had a duty to inform her of the personal liability she was undertaking for all taxes, interest, and penalties by filing jointly instead of separately.<sup>521</sup> The plaintiff apparently also alleged that the defendant should have ascertained that the marital home was owned solely by her.<sup>522</sup>

After trial, the court held that, as a tax return preparer, the defendant had no duty to speak with both spouses to independently verify information provided him, or to inform the plaintiff about the additional liability she was exposing herself to by filing jointly rather than separately.<sup>523</sup> In short,

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<sup>513</sup> *Id.*

<sup>514</sup> *Id.*

<sup>515</sup> *Id.*

<sup>516</sup> *Id.*

<sup>517</sup> *Id.*

<sup>518</sup> *Id.*

<sup>519</sup> *Id.*

<sup>520</sup> *Id.*

<sup>521</sup> *Id.* at \*2.

<sup>522</sup> *See id.*

<sup>523</sup> *Id.* at \*3.

the court held that these matters were beyond the scope of engagement to prepare tax returns.<sup>524</sup>

The court also held that even if the defendant did have a duty to inform plaintiff of the risks of filing jointly, his breach still was not actionable since there was no evidence of proximate causation.<sup>525</sup> The plaintiff never introduced any evidence to indicate that if she had received the warning not to file jointly she would have changed her longstanding practice of filing joint returns and following her husband's instructions on financial matters.<sup>526</sup> The trial court dismissed the plaintiff's complaint and granted judgment to the defendant on his counterclaim for his fees.<sup>527</sup> The New Jersey Appellate Division affirmed.<sup>528</sup>

In *Miller v. Volk*, at trial the plaintiff recovered from the defendant accountant an amount equal to additional taxes and interest assessed by the IRS against his personal service corporation ("PSC") for 1996.<sup>529</sup> The defendant was a CPA who was engaged to prepare the plaintiff's personal income tax return for 1995 and the PSC's 1996 income tax return.<sup>530</sup> The error at issue was that the accountant deducted the full amount of salary the PSC paid the plaintiff in 1996, notwithstanding a limit contained in the Internal Revenue Code on such deductions when a PSC has a fiscal tax year obtained under I.R.C. section 444.<sup>531</sup> On appeal the trial court's decision in favor of the plaintiff was reversed.<sup>532</sup> The primary reason for the reversal was that the alleged negligence was never proven, since the plaintiff never established that the PSC was subject to the salary deduction limitation.<sup>533</sup> Also, the defendant had never given the plaintiff any tax planning advice, nor did he ever assume any responsibility for the PSC's payroll.<sup>534</sup> He had only agreed to prepare the tax return based on the facts as they existed for 1996.<sup>535</sup> In addition, the court held that there were no actionable damages since penalties were not imposed by the IRS, there was no proof that the

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<sup>524</sup> *See id.*

<sup>525</sup> *Id.*

<sup>526</sup> *Id.* at \*3-4.

<sup>527</sup> *Id.* at \*2.

<sup>528</sup> *Id.* at \*5.

<sup>529</sup> 825 N.E.2d 579, 580 (Mass. App. Ct. 2005).

<sup>530</sup> *Id.*

<sup>531</sup> *Id.* at 580-81.

<sup>532</sup> *Id.* at 582.

<sup>533</sup> *Id.* at 581.

<sup>534</sup> *Id.* at 582.

<sup>535</sup> *Id.*



interest paid the IRS on the deficiency exceeded the value to the plaintiff of having use of the money, and the tax assessed by the IRS was simply what the taxpayer owed and nothing in excess of that amount.<sup>536</sup>

With respect to the court's analysis of damages, it is noteworthy that the court seems to have followed the more modern, intermediate view concerning the recovery of interest, but without expressly focusing on the current three-way split on this issue.<sup>537</sup>

One aspect of the lower court's decision concerning damages is also noteworthy. While the lower court permitted the recovery of the additional tax assessed by the IRS, and presumably paid, it denied any recovery for a corresponding state tax deficiency that had not yet been asserted by the state.<sup>538</sup>

In *Parsons & Whittemore Corp. v. Schwartz*, one of the many issues in contention between the parties was whether the defendant, who originally was the plaintiff corporation's tax counsel and subsequently became its president and chief operating officer, had agreed to file personal tax returns for certain members of the family controlling the plaintiff.<sup>539</sup> The court denied the plaintiffs' summary judgment motion on this issue, since further evidence was necessary.<sup>540</sup>

## 2. Conflict of Interest

In *Price v. Ragland*, the transactions facially at issue were a redemption of stock and representation in an estate/gift tax dispute.<sup>541</sup> However, the underlying legal issues really concerned the conflicts of interest by the defendant attorney.<sup>542</sup> TBC was a corporation that had 5,000 shares of stock outstanding at the beginning of the relevant time period.<sup>543</sup> The shares were owned by Tully Turner (3,300), his son Buddy (612), and a trust for Tully's other three children (1,088).<sup>544</sup> Tully was the trustee of the Children's

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<sup>536</sup> *Id.* at 581–82.

<sup>537</sup> See *Recovery of Interest*, *supra* note 43, at 4 (This view permits the recovery of interest only when the interest paid the government on a tax underpayment exceeds the value to the plaintiff of having had the use of the money in the meantime.).

<sup>538</sup> *Miller*, 825 N.E.2d at 580.

<sup>539</sup> See 387 F. Supp. 2d 368, 370–72 (S.D.N.Y. 2005).

<sup>540</sup> *Id.* at 373.

<sup>541</sup> 966 So. 2d 246, 248 (Ala. 2007).

<sup>542</sup> *Id.* at 253.

<sup>543</sup> *Id.* at 248.

<sup>544</sup> *Id.*

Trust.<sup>545</sup> The attorney for TBC was the defendant, Price, a friend of the Turner family.<sup>546</sup>

In 1983 Tully suffered a brain aneurism.<sup>547</sup> Immediately before surgery he signed a power of attorney giving his son, Buddy, authority to handle his business and personal affairs.<sup>548</sup> Following surgery, Tully suffered two massive strokes and became severely incapacitated and unable to work or handle any of his personal affairs.<sup>549</sup> In 1986, Buddy, who had become the president of TBC, consulted defendant Price and TBC's accountant about a tax efficient way to generate the income needed to pay for Tully's medical care.<sup>550</sup> Based on the advice, it was decided that TBC would redeem a large percentage of its outstanding stock.<sup>551</sup> TBC ended up purchasing the shares owned by Tully and the Children's Trust, leaving Buddy as the sole shareholder.<sup>552</sup> Since TBC was not publicly traded, a large accounting firm was retained to value the shares for the redemption.<sup>553</sup> Based on a draft report valuing each share at \$496, the redemption occurred in 1986 using a value of \$500 per share.<sup>554</sup> In the redemption transactions Buddy, as president of TBC, acted on behalf of TBC, and he also acted on behalf of Tully as his attorney-in-fact.<sup>555</sup> Although never appointed as a successor trustee for the Children's Trust, he effected the transaction on behalf of the Children's Trust in his capacity as attorney-in-fact for Tully, who was the named trustee of the trust.<sup>556</sup> In these transactions Price was the only attorney involved and he represented TBC and Tully.<sup>557</sup> There was disputed evidence at trial as to whether he also represented the trust.<sup>558</sup>

Tully died testate in 1991.<sup>559</sup> The beneficiaries of his will were a marital trust for his wife and a trust for Tully's four children (Buddy and his three

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<sup>545</sup> *Id.*

<sup>546</sup> *Id.*

<sup>547</sup> *Id.*

<sup>548</sup> *Id.*

<sup>549</sup> *Id.*

<sup>550</sup> *Id.*

<sup>551</sup> *Id.*

<sup>552</sup> *Id.* at 248–49.

<sup>553</sup> *Id.* at 249.

<sup>554</sup> *Id.*

<sup>555</sup> *Id.*

<sup>556</sup> *Id.*

<sup>557</sup> *Id.* at 255.

<sup>558</sup> *Id.* at 249 n.2.

<sup>559</sup> *Id.* at 249.

siblings).<sup>560</sup> Defendant Price represented the estate in connection with probate of the estate.<sup>561</sup>

In 1994, in connection with the estate's tax return, the IRS contested the \$500 per share value used for the 1986 stock redemptions.<sup>562</sup> The IRS preliminarily decided the shares were then worth \$1,422.<sup>563</sup> As a result, when Tully sold his shares for an understated price, the IRS asserted he was making a gift of approximately \$3 million, thereby resulting in additional gift tax liability of over \$1 million.<sup>564</sup> Price represented the estate in its dispute with the IRS from its inception until the spring of 1996, which was shortly before the dispute was settled in September 1996.<sup>565</sup> Although Price did associate with another attorney experienced in handling similar disputes with the IRS, he often communicated with the entire Turner family concerning the IRS dispute.<sup>566</sup> He advised the executors of Tully's estate, Buddy as president of TBC, and Buddy as trustee of the Children's Trust about the dispute, about their fiduciary obligations and about possible courses of action if the IRS's valuation should ultimately prevail.<sup>567</sup> He advised the executors whether there might be a cause of action by the estate and the beneficiaries of the Children's Trust against Buddy in connection with the redemption.<sup>568</sup> He also advised Buddy and TBC about the consequences to them if the IRS's valuation prevailed.<sup>569</sup> During the entire time that Price was communicating with and representing multiple parties with conflicting interests, he never disclosed the conflict nor attempted to obtain waivers from any of the parties.<sup>570</sup>

The dispute with the IRS was settled in September 1996 on the basis that the shares were worth \$665 per share.<sup>571</sup> In November 1996, the executors and beneficiaries of Tully's estate and the trustee and beneficiaries of the Children's Trust sued Buddy, TBC, the accountant, and defendant Price in connection with the redemption, asserting a number of

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<sup>560</sup> *Id.*

<sup>561</sup> *Id.*

<sup>562</sup> *Id.*

<sup>563</sup> *Id.*

<sup>564</sup> *Id.*

<sup>565</sup> *Id.* at 250, 253.

<sup>566</sup> *Id.* at 250.

<sup>567</sup> *Id.* at 250–51.

<sup>568</sup> *Id.* at 251–52.

<sup>569</sup> *Id.* at 252–53.

<sup>570</sup> *Id.* at 253.

<sup>571</sup> *Id.*

causes of action, ultimately seeking rescission and reimbursement for all distributions made with respect to the shares between 1986 and 1996.<sup>572</sup> They also asserted claims against Price for fraud and negligence in connection with the conflict of interests from 1986 to 1996 in the redemption and the subsequent representations through settlement of the IRS dispute.<sup>573</sup> Subsequently, the plaintiffs settled with Buddy and TBC but retained the right to proceed against Price.<sup>574</sup> At trial against only Price, the plaintiffs received a judgment of \$400,000 in compensatory damages and \$700,000 in punitive damages.<sup>575</sup> The punitive damages later were remitted as excessive due to Price's dire financial condition.<sup>576</sup>

On appeal, the compensatory damages awarded were reversed.<sup>577</sup> Initially, though the court held the statute of limitations did not bar this action, it held that damages relating to the 1986 stock redemption were not recoverable since that wrong occurred outside the open statute of limitations period.<sup>578</sup> The damages allegedly resulting from defendant Price's conflict of interest on the IRS dispute representation consisted of an assertion that, instead of contesting the IRS's value of the shares in 1986, the parties could have sought rescission of the redemption transactions, thereby resolving the matter differently, and presumably, more favorably.<sup>579</sup> The court found, however, that the plaintiffs had not proven they would have pursued the alternative strategy.<sup>580</sup> To rescind would have required paying back all amounts received from the redemption, and there was no evidence the parties had the wherewithal to do this.<sup>581</sup> Also, the amount of estate tax and other savings if the alternative courses were pursued were not established by the plaintiffs.<sup>582</sup> Accordingly, the court held these asserted damages were speculative and not recoverable.<sup>583</sup>

Although not involving a scope of engagement issue, *Graham v. Welch, Roberts and Amburn, LLP* illustrates a miscommunication between a

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<sup>572</sup> *Id.* at 254.

<sup>573</sup> *Id.*

<sup>574</sup> *Id.* at 255.

<sup>575</sup> *Id.* at 257.

<sup>576</sup> *Id.* at 258.

<sup>577</sup> *Id.*

<sup>578</sup> *Id.* at 262.

<sup>579</sup> *Id.*

<sup>580</sup> *Id.* at 264.

<sup>581</sup> *See id.*

<sup>582</sup> *Id.*

<sup>583</sup> *Id.* at 265.

taxpayer and his accountant that could have easily have been avoided.<sup>584</sup> In *Graham*, the plaintiff received a notice that he owed \$4,296.49 of taxes to New York State.<sup>585</sup> He issued a check for this amount and sent it to the defendant accountant, intending for the accountant to pay the tax bill.<sup>586</sup> There was evidence that the defendant accountant in the past had paid certain expenses for the plaintiff.<sup>587</sup> The accountant applied the check toward his fees.<sup>588</sup> Subsequently, the plaintiff's bank account was levied upon by New York State for the unpaid taxes.<sup>589</sup> The appellate court affirmed the trial court's grant of summary judgment to the defendant accountant on statute of limitations grounds.<sup>590</sup> The court agreed that the plaintiff should have realized the error when he received a bill from his accountant with a credit in the precise amount of his payment.<sup>591</sup>

## B. Tax Filing and Tax Preparation

### 1. Late Filing and Non-Filing

To file a client's tax return late, or not to file it at all, seems to be one of the most obvious types of professional negligence one could imagine in the tax area. A prominent commentator noted that "[t]he vast majority of malpractice cases arising in the return preparation context involve the practitioner's failure to file the client's tax return on a timely basis."<sup>592</sup> It is therefore a bit puzzling that in 2007 a lower court in New York needed to look to cases in other states as authority for this type of cause of action.<sup>593</sup> In *Blumberg v. Altman*, the plaintiff alleged that the defendant accountant filed his federal, New York State, and New York City income tax returns late for 2004 and 2005 and that the defendant failed to obtain an extension for filing in 2005.<sup>594</sup> As a result, the plaintiff incurred penalties, interest and

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<sup>584</sup> See 743 S.E.2d 860, 861 (S.C. Ct. App. 2013).

<sup>585</sup> *Id.*

<sup>586</sup> *Id.*

<sup>587</sup> *Id.*

<sup>588</sup> *Id.*

<sup>589</sup> *Id.*

<sup>590</sup> *Id.* at 863.

<sup>591</sup> *Id.*

<sup>592</sup> WOLFMAN ET AL., *supra* note 20, § 605.2.1.

<sup>593</sup> See *Blumberg v. Altman*, 118264/06, 2007 WL 1519067, at \*2 (N.Y. Sup. Ct. May 25, 2007).

<sup>594</sup> *Id.* at \*1.

late fees, which he was seeking to recover in this action.<sup>595</sup> Although upholding the cause of action, the court stated:

Although New York courts are familiar with accounting malpractice based on late filings, it appears that they have not had occasion to reach the issue of whether an accountant's failure to file returns on time and file the appropriate extensions states a valid cause of action for accounting malpractice. However, courts in other jurisdictions have expressly recognized these allegations as a valid cause of action.<sup>596</sup>

In upholding the pro se plaintiff's malpractice cause of action from the defendant's motion to dismiss, the court did note that in New York interest paid the IRS is not recoverable as damages because it is viewed simply as an appropriate charge for the use of money the plaintiff had during a period of time he was not entitled to it.<sup>597</sup> The court, rather perceptively, added that penalties incurred by a plaintiff are different and are recoverable.<sup>598</sup>

*Bryant v. Golden* also involved a suit by a taxpayer against his accountant for the interest and penalties incurred when the accountant failed to file his 2000 federal income tax return.<sup>599</sup> The case, however, dealt solely with statute of limitations issues and affirmed the lower court's holding that the suit was barred by the statute of limitations.<sup>600</sup>

*Pair v. Queen* revolved around the late filing of federal and District of Columbia estate tax returns.<sup>601</sup> Penalties and interest of more than \$1 million were incurred as a result and were sought to be recovered by the plaintiffs from the defendants.<sup>602</sup> The primary defendant, Queen, was an attorney who was both a co-representative of the estate and the estate's attorney with respect to preparing and filing its tax returns.<sup>603</sup> The other

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<sup>595</sup> *Id.*

<sup>596</sup> *Id.* at \*2 (citations omitted).

<sup>597</sup> *Id.* at \*1, \*2. For a critique of this New York approach see Todres, *NY: Balanced or Biased supra* note 42, at 149.

<sup>598</sup> *Blumberg*, 2007 WL 1519067, at \*1.

<sup>599</sup> 691 S.E.2d 672, 673 (Ga. Ct. App. 2010).

<sup>600</sup> *Id.*

<sup>601</sup> 2 A.3d 1063, 1065 (D.C. 2010). There is also an allegation that the tax returns were improperly prepared in addition to having been filed almost a year and a half late. There is no indication of what was done improperly.

<sup>602</sup> *Id.*

<sup>603</sup> *Id.*

defendants were an attorney and accountant who allegedly assisted Queen in preparing the estate's tax returns.<sup>604</sup> The plaintiffs were beneficiaries under the decedent's will and also co-representatives of the estate.<sup>605</sup> This case, however, did not address the substance of the malpractice issue.<sup>606</sup> It focused solely on reversing the lower court's incorrect dismissal of the malpractice claims on non-substantive grounds.<sup>607</sup> The lower court had also ignored the fact that the plaintiffs were also heirs under the will, not merely co-personal representatives with defendant Queen.<sup>608</sup> In addition, the lower court also misconstrued *United States v. Boyle* as preventing this malpractice action.<sup>609</sup>

*Hillbroom v. PricewaterhouseCoopers LLP* involves the alleged failure to file a refund claim for overpaid federal estate taxes.<sup>610</sup> *Hillbroom* involves the sizeable estate of one of the co-founders of DHL, the international express delivery business.<sup>611</sup> As part of the settlement of litigation involving the heirs and beneficiaries of the estate, the defendant accounting firm and one of its tax attorney employees, Gregory Jenner, were retained to represent the estate to pursue estate tax refund claims.<sup>612</sup> Allegedly, when the previous tax counsel met with Jenner they informed him of the need to pursue a refund claim because additional administrative expenses and other deductible amounts were incurred after the tax return was filed.<sup>613</sup> Jenner apparently acknowledged the need to file the refund claim for these amounts but did not want to do so until a previous refund claim that was then pending was received.<sup>614</sup> Ultimately, the second refund claim was not timely filed and this suit for over \$6 million was brought.<sup>615</sup> The lower court dismissed the suit on statute of limitations grounds, and the

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<sup>604</sup> *Id.*

<sup>605</sup> *Id.*

<sup>606</sup> *See id.* at 1066.

<sup>607</sup> *Id.*

<sup>608</sup> *See id.*

<sup>609</sup> *Id.* (*Boyle* stands for the proposition that a taxpayer's reliance upon an attorney to prepare and file a tax return does not constitute reasonable cause to defeat a late filing penalty. It never addressed whether the penalty may be recovered from the attorney. *See* 469 U.S. 241, 242 (1985)).

<sup>610</sup> 17 A.3d 566, 568 (D.C. 2011).

<sup>611</sup> *Id.* at 568 n.1.

<sup>612</sup> *Id.* at 570.

<sup>613</sup> *Id.*

<sup>614</sup> *Id.*

<sup>615</sup> *Id.* at 571.

court of appeals reversed and remanded for further fact finding concerning several statute of limitations issues.<sup>616</sup>

*Goodman v. Hanson* involves interesting procedural issues arising from several tax malpractice disputes.<sup>617</sup> In *Goodman*, the defendant was the attorney for an estate of which the plaintiff was the executor and the principal beneficiary, as well as the trustee of a related trust.<sup>618</sup> In 2005, the plaintiff sued the defendant for the damages resulting from the failure to timely file an Illinois estate and generation skipping tax return.<sup>619</sup> This suit was settled in December 2005 with the defendant paying the plaintiff \$35,000 and releasing any claims for unpaid legal fees.<sup>620</sup> The parties signed a general release that was approved by the probate court.<sup>621</sup> In January 2007, the plaintiff filed a second suit against the defendant arising out of the same facts, but this time alleging malpractice based on the defendant's failure to take certain deductions on the federal estate tax return.<sup>622</sup> It seems that most of the deductions were taken on the trust's income tax return rather than on the estate tax return even though the estate's marginal tax rate was higher than the trust's.<sup>623</sup> The issue before the Illinois intermediate appellate court was whether the second suit was barred by either the general release or res judicata.<sup>624</sup> The court held the general release barred the second suit.<sup>625</sup>

Several other cases arising from late filing or non-filing should be noted. *Ballreich Bros. v. Criblez* involved errors on a payroll tax return and the untimely filing of an amended payroll tax return.<sup>626</sup> In *Ballreich*, the taxpayer sued the accountant and his firm, seeking damages for malpractice.<sup>627</sup> The case revolved around the accountant's third-party complaint against the attorney who had provided the incorrect advice that caused the problem.<sup>628</sup> The court held that the trial court should not have

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<sup>616</sup> *Id.* at 573, 579, 581.

<sup>617</sup> *See* 945 N.E.2d 1255, 1258 (Ill. App. Ct. 2011).

<sup>618</sup> *Id.*

<sup>619</sup> *Id.* at 1258–59.

<sup>620</sup> *Id.* at 1259.

<sup>621</sup> *Id.* at 1259–60.

<sup>622</sup> *Id.* at 1260.

<sup>623</sup> *Id.*

<sup>624</sup> *Id.* at 1263, 1268.

<sup>625</sup> *Id.* at 1270.

<sup>626</sup> No. 05–09–36, 2010 WL 2735733, at \*4 (Ohio Ct. App. July 12, 2010).

<sup>627</sup> *Id.* at \*1.

<sup>628</sup> *Id.*



dismissed the third party complaint with prejudice because it was inadequately pled, since the cause of action could have been revised to cure the pleading defect.<sup>629</sup> The problem with the pleading was that it simply claimed the advice given by the attorney was incorrect.<sup>630</sup> There was no allegation that the advice was negligent, that it fell below applicable standards or that the attorney breached any duty owed the client.<sup>631</sup>

In *Murphey v. Grass*, the plaintiff had retained the defendant accounting firm to manage all bookkeeping and accounting services for his two businesses and to prepare all payroll and other tax returns.<sup>632</sup> The defendant's accountant was negligent in performing the work.<sup>633</sup> It turned out the IRS had filed liens and that the plaintiff owed approximately \$100,000 in employment taxes and interest.<sup>634</sup> Subsequently, the State of Washington determined that over \$185,000 was owed for additional retailing, sales and use taxes plus interest and penalties.<sup>635</sup> Only the additional state amounts were the subject of this litigation.<sup>636</sup> The Washington Court of Appeals held that for statute of limitations purposes the liability for these amounts accrued under Washington law only after all administrative appeals were finally concluded and that this action was timely.<sup>637</sup>

At the heart of the dispute in *A. Morrison Trucking, Inc. v. Bonfiglio* was the fact that the plaintiff incurred almost \$79,000 in penalties and interest for approximately three years, beginning March 31, 1999, because his accountant failed to make payroll tax deposits, file tax returns or respond to IRS tax due notices in a timely fashion.<sup>638</sup> The defendant, Bonfiglio, owned the tax service that was to provide these various accounting services to the plaintiff.<sup>639</sup> The person who actually performed the services was Allan Keizer.<sup>640</sup> Keizer initially was an employee of

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<sup>629</sup> *Id.* at \*3.

<sup>630</sup> *Id.*

<sup>631</sup> *Id.*

<sup>632</sup> 267 P.3d 376, 377 (Wash. Ct. App. 2011).

<sup>633</sup> *Id.* at 378.

<sup>634</sup> *Id.* at 377.

<sup>635</sup> *Id.* at 377–78.

<sup>636</sup> *See id.* at 378 n.10.

<sup>637</sup> *Id.* at 381–82.

<sup>638</sup> No. 25917/05, slip op. at \*1 (N.Y. Sup. Ct. Sept. 18, 2006).

<sup>639</sup> *Id.*

<sup>640</sup> *Id.*

defendant's accounting service.<sup>641</sup> At some point during the relevant time period Keizer formed his own company and continued to perform the accounting services for the plaintiff.<sup>642</sup> It is unclear when the transition occurred and, therefore, who was responsible for what damages.<sup>643</sup> These causes of action were dismissed on statute of limitations grounds.<sup>644</sup>

*Morgan v. Fennimore* involved a suit for damages by a taxpayer against his CPA tax return preparer for failing to file a state income tax return.<sup>645</sup> The defendant accountant annually prepared the plaintiff's federal and Indiana income tax returns from 1990 until 2007.<sup>646</sup> Prior to 1990, the plaintiff had won \$25 million from the Ohio State Lottery.<sup>647</sup> From 1990 until 2003, the plaintiff was receiving annual payments from the lottery.<sup>648</sup> Although each year Ohio sent a Form W-2G for the lottery payments, the defendant CPA never prepared or filed an Ohio income tax return for the plaintiff.<sup>649</sup> In 2008, a notice was received from Ohio demanding almost \$1.8 million in tax liabilities, fees and interest.<sup>650</sup> This suit ensued.<sup>651</sup> The court never reached the substance, since it granted summary judgment to the defendant on statute of limitation grounds.<sup>652</sup>

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<sup>641</sup> *Id.*

<sup>642</sup> *Id.*

<sup>643</sup> *See id.*

<sup>644</sup> *Id.* at \*5. The causes of action were framed as breach of contract and negligence causes of action. *Id.* A fraud cause of action asserted by the plaintiff against the defendant, who was also an attorney, was permitted to proceed. *Id.* at \*7-8. In mid-2002, the plaintiff learned that his tax situation was mishandled and demanded payment from Keizer and Bonfiglio. *Id.* at \*3. He claimed that Bonfiglio assured him the fault was entirely Keizer's and that Keizer possessed the means to repay the plaintiff. *Id.* Subsequently, Bonfiglio prepared a promissory note and affidavit of confession of judgment signed by Keizer in favor of the plaintiff and a release agreement that apparently also released any claims by the plaintiff against Bonfiglio. *Id.* The promissory note and the confession of judgment contained misspellings of Keizer's name and were legally invalid. *Id.* at \*4. The plaintiff alleged this was done intentionally by the defendant to prevent the plaintiff from successfully proceeding against the defendant because the defendant still owed Bonfiglio money for the accounts he had purchased from him. *Id.* at \*6. In addition, Bonfiglio acted as attorney for the plaintiff in 2001 and his failure to advise the plaintiff that Bonfiglio might be responsible for the damages as Keizer's employer may also have been improper. *Id.* at \*3, \*6.

<sup>645</sup> No. 1:09-cv-399-SEB-TAB, 2010 WL 5057418, at \*1-2 (S.D. Ind. Dec. 3, 2010).

<sup>646</sup> *Id.* at \*1.

<sup>647</sup> *Id.*

<sup>648</sup> *Id.*

<sup>649</sup> *Id.*

<sup>650</sup> *Id.* at \*2.

<sup>651</sup> *Id.*

<sup>652</sup> *Id.* at \*6.

Although not addressed in the case, another lapse by the defendant occurred which, perhaps, could be the basis for a malpractice suit.<sup>653</sup> In early 2003, the plaintiff informed the defendant that he had moved to Washington state.<sup>654</sup> Nevertheless, the defendant prepared a full-year Indiana tax return for the plaintiff.<sup>655</sup>

Several cases involve an error by an accountant as to which state was the taxpayer's state of residence.<sup>656</sup> However, neither of the cases focused on the substance of the allegation.<sup>657</sup> In *Choina v. Albanese*, the plaintiff was a New York resident who lived in New Jersey.<sup>658</sup> For 2005 and 2006, the defendant accountant prepared New York state tax returns for her.<sup>659</sup> The plaintiff later learned she should have filed in New Jersey and owed approximately \$225,000 in taxes, interest, and penalties.<sup>660</sup> The statute of limitations had run on amending the New Jersey returns for amounts paid in New York.<sup>661</sup> The claim was dismissed on statute of limitations grounds.<sup>662</sup>

In *Rakoff v. St. Clair, CPAs, P.C.*, the plaintiff allegedly advised the defendant CPA that during 2007 he owned residential properties in four states: Pennsylvania, New York, New Jersey, and Ohio.<sup>663</sup> Instead of discussing the indicia of residency in each state, the defendant advised the plaintiff to file as a resident of Pennsylvania and a nonresident of New York, allegedly because that would result in the smallest tax liability.<sup>664</sup> New York subsequently instituted an audit.<sup>665</sup> This suit was instituted for the initial advice, for errors made in connection with the New York audit, for failing to file amended Pennsylvania returns and for failing to advise the plaintiff of the statute of limitations for filing amended returns in

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<sup>653</sup> *See id.* at \*2.

<sup>654</sup> *Id.*

<sup>655</sup> *Id.* The court indicated that the defendant prepared Indiana state tax returns for the defendant from 1990 until 2007. *Id.* at \*1. The court never focused on this discrepancy.

<sup>656</sup> *See, e.g., Morgan*, 2010 WL 5057418, at \*2; *Choina v. Albanese*, No. 12-CV-3241, 2013 WL 1316747, at \*1 (E.D.N.Y. Mar. 29, 2013).

<sup>657</sup> *See Morgan*, 2010 WL 5057418, at \*6; *Choina*, 2013 WL 1316747, at \*2.

<sup>658</sup> *Choina*, 2013 WL 1316747, at \*1.

<sup>659</sup> *Id.*

<sup>660</sup> *See id.*

<sup>661</sup> *Id.*

<sup>662</sup> *Id.* at \*2.

<sup>663</sup> No. 12-5996, 2013 WL 1007330, at \*1 (D.N.J. Mar. 12, 2013).

<sup>664</sup> *Id.*

<sup>665</sup> *Id.* The case does not indicate what resulted from the audit.

Pennsylvania.<sup>666</sup> The case revolved primarily around statute of limitations issues.<sup>667</sup> The court held the statute was open and denied the defendant's motion to dismiss.<sup>668</sup>

## 2. Negligent Preparation

This section focuses on errors involved in the return preparation process. Several cases simply assert that defective or erroneous returns were prepared without specifying the underlying facts in enough detail to enable any useful analysis.<sup>669</sup> These cases, by and large, are ignored. Cases that result from the misapplication of a specific tax code provision, deduction or tax concept will be discussed subsequently.<sup>670</sup> It is interesting to note that most of the cases in this section involve motions to dismiss or for summary judgment and often involve claims that the statute of limitations has run. It is likely that a reasonably thorough review of the current state of the law concerning when the statute of limitations commences to run and when it is tolled can be gleaned just from these cases. As a preliminary matter, *Andrew Shebay & Co. v. Bishop* held that a taxpayer who was criminally convicted of filing a false tax return and tax evasion was precluded from seeking damages from the accountant who prepared the return.<sup>671</sup> Collateral estoppel bars the subsequent malpractice suit since the criminal conviction necessarily determines that the taxpayer acted intentionally or willfully.<sup>672</sup> The court also held that Texas public policy prohibits the taxpayer from recovering damages from his own illegal acts.<sup>673</sup>

*Weiss v. Deloitte & Touch, LLP*, one of the cases that does not specify the underlying negligence with enough detail to enable analysis, is noteworthy because it also involves a cause of action against the accountant defendants for negligently reviewing tax returns prepared by the plaintiffs'

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<sup>666</sup> *Id.* at \*1–2.

<sup>667</sup> *See id.* at \*3.

<sup>668</sup> *See id.* at \*4.

<sup>669</sup> *See, e.g.*, *Beane v. Dana S. Beane & Co.*, 7 A.3d 1284, 1287 (N.H. 2010); *Hickey v. O'Connor & Drew, P.C.*, No. CIV–09–349–C, 2009 WL 2163499, at \*1 (W.D. Okla. July 10, 2009); *Weiss v. Deloitte & Touche, LLP*, 882 N.Y.S.2d 229, 231 (App. Div. 2009); *Lally v. Winkler & Co.*, No. 4478/11, 2010 WL 8356958 (N.Y. Sup. Ct. Dec. 23, 2010); *Kennedy v. Goffstein*, 815 N.E.2d 646, 647 (Mass. App. Ct. 2004).

<sup>670</sup> Admittedly, the categorization process is very imprecise, and certain cases could just as logically be placed elsewhere.

<sup>671</sup> 429 S.W.3d 644, 646 (Tex. App.—Houston [1st Dist.] 2013, pet. denied).

<sup>672</sup> *Id.* at 648.

<sup>673</sup> *Id.*

prior accountants.<sup>674</sup> The substance of this cause of action was not addressed since New York's Appellate Division for the Second Department affirmed the trial court's dismissal of this cause of action on statute of limitations grounds.<sup>675</sup>

In *Penner v. Hoffberg Oberfest Burger & Berger*, the plaintiff sought to recover fees he paid to accountants in connection with audits of his 1994-1996 tax returns on the theory that the audits of these years were caused by the defendant accountants "taking improper losses and deductions in his 1994 tax return."<sup>676</sup> New York's First Department had little trouble affirming the lower court's dismissal of this cause of action because the court did not believe the asserted facts.<sup>677</sup> Instead, the court found that the plaintiff likely was targeted for IRS tax scrutiny because of errors in, and the audit of, the 1994 tax return of an "S" corporation in which the plaintiff was a shareholder, which return was prepared by different accountants.<sup>678</sup>

The court in *Penner* nevertheless proceeded to address the substance of the asserted cause of action.<sup>679</sup> The court stated that the plaintiff's expenditures in defending the audits were not recoverable, even if the alleged malpractice did cause the audits, where there was no evidence that the error caused a tax liability that otherwise would not have existed.<sup>680</sup> "Plaintiff is not entitled to the cost of trying to convince the tax authorities that he should not have to pay taxes he legitimately owed but would have avoided had the 1994 return been prepared in a way that did not red-flag the potential for abuse."<sup>681</sup>

The court here is answering in the negative the often-asked question whether any damages may be recovered when some tax malpractice triggers an audit that uncovers other, non-related, taxes to be due.<sup>682</sup> The court emphatically answers that neither the other taxes nor the costs of defending the audit are recoverable.<sup>683</sup>

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<sup>674</sup> 882 N.Y.S.2d 229, 231 (App. Div. 2009).

<sup>675</sup> *Id.* at 231-32.

<sup>676</sup> 844 N.Y.S.2d 229, 230 (App. Div. 2007). Other portions of plaintiff's asserted causes of action were also dismissed. *See* 755 N.Y.S.2d 835, 836 (App. Div. 2003).

<sup>677</sup> *See Penner*, 844 N.Y.S.2d at 230.

<sup>678</sup> *Id.*

<sup>679</sup> *See id.*

<sup>680</sup> *Id.*

<sup>681</sup> *Id.*

<sup>682</sup> *See generally, Tax Malpractice Damages, supra* note 38, at 756-58.

<sup>683</sup> *Penner*, 844 N.Y.S.2d at 230.

In *Penner*, the First Department also held the plaintiff may not recover the fees he paid the defendants for preparation of the returns that were audited.<sup>684</sup> The court found that the plaintiff received something of value in return for the fees—tax returns, whether or not correct, that were accepted by the IRS, though subject to adjustment.<sup>685</sup>

*Shaiman v. Carpet One of the Hamptons, Inc.* stands in partial contrast to *Penner*.<sup>686</sup> In *Shaiman*, the plaintiff was the defendant's accountant for more than ten years until 2007.<sup>687</sup> During this time, the plaintiff prepared the defendant's income tax returns and New York State sales tax returns.<sup>688</sup> With respect to the sales tax returns, the plaintiff simply reported the amounts given him by the defendant's bookkeeper without any independent verification.<sup>689</sup> For the year 2000, the sales reported on the sales tax returns differed from the sales reported on the income tax returns by \$1.3 million.<sup>690</sup> As a result, the defendant was subjected to a sales tax audit for March 1, 2000 to November 30, 2002.<sup>691</sup> This initial audit was later followed by a compliance audit for December 1, 2002 through February 28, 2006.<sup>692</sup> As a result of the audits, the defendant ended up paying approximately \$500,000 in additional sales taxes and \$134,000 in interest.<sup>693</sup> The plaintiff spent a total of over 150 hours working on both audits and brought this action to collect his fees of \$15,000.<sup>694</sup> The defendant counterclaimed for damages flowing from the plaintiff's negligence in preparing the 2000 tax returns in failing to discover the \$1.3 million discrepancy between the sales figures reported on the federal income tax return and the sales tax return.<sup>695</sup>

The damages sought by the defendant are very interesting.<sup>696</sup> During closing argument, defendant's counsel withdrew the defendant's claim for

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<sup>684</sup> *Id.* at 231.

<sup>685</sup> *Id.*

<sup>686</sup> See No. BRC 208-08, 2010 WL 2305549, at \*5, \*9 (Dist. Ct. Suffolk Co. June 9, 2010).

<sup>687</sup> *Id.* at \*1.

<sup>688</sup> *Id.* at \*1, \*3.

<sup>689</sup> *Id.* at \*1.

<sup>690</sup> *Id.* at \*3.

<sup>691</sup> *Id.* The auditor on the initial audit testified that the \$1.3 million discrepancy probably caused the sales tax audit.

<sup>692</sup> *Id.*

<sup>693</sup> See *id.* at \*3-4.

<sup>694</sup> *Id.* at \*2.

<sup>695</sup> *Id.* at \*5-6.

<sup>696</sup> See *id.* at \*8.

the additional taxes since the defendant actually owed the taxes.<sup>697</sup> This is consistent with *Penner* and with New York law that taxes owed are not recoverable from a negligent tax advisor.<sup>698</sup> As to the interest on the underpayment of the sales taxes, the court followed established New York law that refuses to award interest in tax underpayment situations.<sup>699</sup> Although the defendant fired the plaintiff in the midst of the second compliance audit and hired a replacement accountant, the plaintiff never introduced any evidence concerning the cost of the replacement accountant, so the court dismissed this counterclaim.<sup>700</sup> Therefore, the only damages asserted were the very same fees the plaintiff was seeking to recover in this suit.<sup>701</sup> The court in *Shaiman* awarded the plaintiff his audit fees of \$15,000 and awarded this same amount as damages to the defendant for the plaintiff's negligence in preparing and not detecting the conflicting sales numbers on the income and sales tax returns and then offset the amounts.<sup>702</sup>

Awarding the defendant damages for the negligent return preparation is inconsistent with *Penner*, in which the court held the taxpayer was not entitled to recover either the cost of the negligent return preparation or the audit defense costs.<sup>703</sup> Initially, *Shaiman* is consistent with *Penner* in awarding the plaintiff CPA compensation for his work on the two audits his negligence caused.<sup>704</sup> But when *Shaiman* awarded the defendant client the same amount as damages flowing from the plaintiff's negligence in submitting tax returns with inconsistent sales numbers, *Shaiman* seems inconsistent with *Penner*.<sup>705</sup> In *Shaiman*, contrary to *Penner*, the audit fees were still unpaid.<sup>706</sup> It may be that the judge in *Shaiman* ultimately did not want the plaintiff CPA, who was quite blameworthy, to obtain any net recovery from the litigation: "Plaintiff should not be compensated for work that it in essence created due to its negligence or could have been altogether avoided had Plaintiff discovered and communicated the discrepancy to

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<sup>697</sup> *Id.*

<sup>698</sup> See 844 N.Y.S.2d 229, 230 (App. Div. 2007); *NY: Balanced or Biased*, *supra* note 42, at 149.

<sup>699</sup> *Shaiman*, 2010 WL 2305549, at \*8; See also *NY: Balanced or Biased*, *supra* note 42, at 149.

<sup>700</sup> *Shaiman*, 2010 WL 2305549, at \*4, \*8.

<sup>701</sup> *Id.* at \*9.

<sup>702</sup> *Id.* at \*5, \*9.

<sup>703</sup> 844 N.Y.S.2d 229, 230 (App. Div. 2007).

<sup>704</sup> *Shaiman*, 2010 WL 2305549, at \*5, \*9.

<sup>705</sup> *Id.* at \*9.

<sup>706</sup> See *id.* at \*2.

Defendant.”<sup>707</sup> It should be emphasized that *Penner* was decided by the First Department, one of New York’s four intermediate appellate courts, while *Shaiman* was decided in Suffolk County District Court, a lower court of very limited jurisdiction.<sup>708</sup>

Several cases revolving about statute of limitations issues illustrate potential negligent return preparation scenarios. In *SK Partners I, LP v. Metro Consultants, Inc.*, the plaintiffs’ cause of action asserted that the defendant accountants, who had prepared income tax returns for a group of related entities, caused the plaintiffs to overpay their taxes by claiming depreciation deductions that were too low.<sup>709</sup> The accountants’ depreciation was calculated on an understated cost basis for the assets to be depreciated.<sup>710</sup> At least part of the overpaid taxes were recovered when new accountants filed amended returns.<sup>711</sup> The damages asserted by the plaintiffs included being required to file amended returns and suffering “‘a loss of the depreciation deductions, excess attorney’s fees and accountant fees,’ as well as ‘a loss of the interest and economic value of the money’ overpaid to the IRS.”<sup>712</sup>

In *Iacurci v. Sax*, the defendant CPA and his firm had prepared the plaintiff’s tax returns from 1989 to 2006.<sup>713</sup> For tax years 1999 through 2002, the returns prepared by the defendants portrayed the plaintiff as a real estate investor.<sup>714</sup> For tax years 2003 through 2005, without informing the plaintiff, the defendant changed this and portrayed the defendant as being “‘engaged in the business of real estate.”<sup>715</sup> According to the plaintiff’s expert, this change caused the plaintiff to overpay his taxes by \$177,000.<sup>716</sup> The precise makeup of the additional taxes and the amount recovered upon

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<sup>707</sup> *Id.* at \*9.

<sup>708</sup> See *Penner* 844 N.Y.S.2d at 229; *Shaiman*, 2010 WL 2305549, at \*1. It was suggested that the plaintiff reduced the amount of fees he sought to recover so as to fall within the \$15,000 limit of the District Court’s subject matter jurisdiction. *Id.* at \*2

<sup>709</sup> 944 N.E.2d 414, 415 (Ill. App. Ct. 2011).

<sup>710</sup> *Id.* at 415 n.1.

<sup>711</sup> *Id.* at 415, 417.

<sup>712</sup> *Id.* at 418.

<sup>713</sup> No. CV095028505S, 2011 WL 1470005, at \*1, \*7 (Conn. Super. Ct. Mar. 25, 2011), *aff’d*, 57 A.3d 736 (Conn. App. Ct. 2012).

<sup>714</sup> *Id.* at \*1.

<sup>715</sup> *Id.*

<sup>716</sup> *Id.* at \*3.



the filing of an amended return is not specified in the opinion.<sup>717</sup> However, in both *Iacurci* and in *SK Partners I*, the causes of action were held to be barred by the statute of limitations, and the substance of the asserted claims was never reached.<sup>718</sup>

In *Sahadi v. Schaeffer*, the case centered on when the California two-year statute of limitations commenced to run for a case of negligent preparation of tax returns that were later audited by the IRS.<sup>719</sup> Here, the taxpayer was more fortunate than the two previous taxpayers, as the California Court of Appeals reversed the trial court and held the plaintiff's suit was timely.<sup>720</sup> The tax returns primarily at issue in *Sahadi* were their 1991 California and federal income tax returns.<sup>721</sup> The returns were prepared by the defendant accountant and filed on April 15, 1992.<sup>722</sup> Within one year, two amended returns were prepared by the defendants and filed by the plaintiffs.<sup>723</sup> Eventually, the California tax authorities and the IRS audited the returns.<sup>724</sup> Large tax deficiencies of over \$35 million were asserted initially by both tax authorities.<sup>725</sup> After more than five years of negotiation, the deficiencies were reversed by both the IRS and the California authorities.<sup>726</sup> The primary negligence of the defendant involved failing to properly document positions taken on the 1991 tax returns.<sup>727</sup> In January of 1991, the taxpayers transferred ownership in a real estate complex consisting of a high rise office building, shopping center and hotels to their lender by deed in lieu of foreclosure.<sup>728</sup> The taxability of the transfer turned on the insolvency of taxpayers at that time, which was

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<sup>717</sup>The filing of amended returns for tax years 2003–2005 is mentioned. *Id.* at \*1. As to the nature of the damages, they presumably result from the difference in being able to utilize long term capital gains tax rates on investment income (typically reported on Schedule D to the federal income tax return) versus having to pay tax at regular tax rates on ordinary business income (typically reported on Schedule C to the federal income tax return). The plaintiff's expert stated the errors discovered were caused by filing a Schedule C rather than a Schedule D. *Id.* at \*3.

<sup>718</sup>*Id.* at \*7; *SK Partners I*, 944 N.E.2d at 415.

<sup>719</sup>66 Cal. Rptr. 3d 517, 520–21 (Ct. App. 2007).

<sup>720</sup>*Id.* at 542–43.

<sup>721</sup>*Id.* at 521.

<sup>722</sup>*Id.*

<sup>723</sup>*Id.*

<sup>724</sup>*Id.* at 521–22.

<sup>725</sup>*Id.* at 522.

<sup>726</sup>*See id.* at 522–23. While the key transactions occurred in 1991, the asserted tax deficiencies were for 1990 through 1995. *Id.* at 522.

<sup>727</sup>*Id.* at 523.

<sup>728</sup>*Id.* at 521.

largely dependent on the value of this and their other property, as well as on the precise amount of their indebtedness.<sup>729</sup> Apparently, the defendants did not have any of the necessary supporting documentation prepared.<sup>730</sup> Similarly, there was no documentation for a net operating loss deduction claimed on the tax return.<sup>731</sup>

*Sahadi* also involved allegations that the defendant accountant was negligent in representing the plaintiffs on the audit.<sup>732</sup> IRS audit reports issued in 1997 criticized the defendant “for failing to (1) provide information the IRS had requested, and (2) offer support for tax positions he had asserted during the audit process.”<sup>733</sup>

The damages asserted by the plaintiffs included almost \$2.3 million in out-of-pocket costs, which seem quite appropriate, but also included emotional distress and economic loss caused by the tax liens needlessly filed against them.<sup>734</sup> The plaintiffs claimed that they lost \$2 million when tax liens filed by the California tax authorities against their thoroughbred horse breeding farm caused them to lose it from a “fire-sale” through foreclosure.<sup>735</sup> Whether this type of loss is recoverable as proximately caused by the negligent tax return preparation is most interesting. Alas, there is no published report of the subsequent disposition of this case, and this issue must await determination by another court.

In *SG Industries, Inc. v. RSM McGladrey, Inc.*, the plaintiff retained the defendant accounting firm for tax consulting services and to prepare its tax returns for 2007 and 2008.<sup>736</sup> In September 2009, a different accounting firm reviewed these tax returns and identified a number of errors that were made both on the federal and state returns which caused the plaintiff to

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<sup>729</sup>*Id.* Normally, when a taxpayer’s debt is discharged without full payment, the amount of the unpaid discharged debt is taxable gross income. *See* I.R.C. § 61(a)(12) (2012). An exception exists if the taxpayer is insolvent when the discharge occurs. I.R.C. § 108(a)(1)(B) (2012). However, the exception is strictly limited and may not exceed the amount of the insolvency. I.R.C. § 108(a)(3) (2012). It is thus a certainty that establishing and proving the amount of a taxpayer’s insolvency will always be necessary whenever this exception to including discharged debt in income is claimed.

<sup>730</sup>*See Sahadi*, 66 Cal. Rptr. 3d at 522.

<sup>731</sup>*Id.* at n.4.

<sup>732</sup>*Id.* at 523–24.

<sup>733</sup>*Id.* at 522.

<sup>734</sup>*Id.* at 524.

<sup>735</sup>*Id.*

<sup>736</sup>No. 10–cv–11119, 2011 WL 6090247, at \*1 (E.D. Mich. Dec. 7, 2011).

overpay its taxes.<sup>737</sup> The plaintiff subsequently commenced this action for malpractice, seeking to recover its losses.<sup>738</sup> While a resolution of certain of the potential substantive issues raised would have been quite informative, it was not to be. The plaintiff's suit was dismissed because the plaintiff never offered any expert testimony, nor even identified expert witnesses, to establish the standard of care, breach of the standard and causation, all of which were necessary elements to establish the cause of action.<sup>739</sup> The plaintiff had hoped to establish its cause of action through defendant's experts.<sup>740</sup> After missing many deadlines to file an expert report, the plaintiff's counsel unsuccessfully sought leave from the court to remedy this defect by filing a rebuttal expert report.<sup>741</sup> When this proved unsuccessful, the plaintiff changed counsel and new counsel attempted to obtain leave to name an expert and provide an expert report.<sup>742</sup> The court, however, would not grant leave.<sup>743</sup> There was evidence that the parties "were engaged in a lengthy and extensive settlement dialogue" and the court viewed the plaintiff's failure to comply as being deliberate, and an attempt to save expert fees.<sup>744</sup>

*Goodman v. Hanson*, discussed previously,<sup>745</sup> involved a claim that the defendant accountant negligently prepared an estate tax return when he failed to claim certain deductions on the estate tax return, and instead claimed the deductions on a related trust's income tax return despite the fact that marginal tax rate for the estate tax return was higher.<sup>746</sup> Taking the deductions on the estate tax return would have saved more taxes than claiming the deductions on the trust's returns.<sup>747</sup> This issue was not addressed by the court since it held the issue was precluded by a general release signed by the litigants in a related case.<sup>748</sup>

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<sup>737</sup> *See id.*

<sup>738</sup> *Id.* at \*2.

<sup>739</sup> *Id.* at \*4, \*9, \*11.

<sup>740</sup> *Id.* at \*5.

<sup>741</sup> *Id.* at \*8.

<sup>742</sup> *Id.*

<sup>743</sup> *Id.*

<sup>744</sup> *Id.* at \*9.

<sup>745</sup> *See supra*, text accompanying notes 617–625.

<sup>746</sup> 945 N.E. 2d 1255, 1260 (Ill. App. Ct. 2011).

<sup>747</sup> *See id.*

<sup>748</sup> *Id.* at 1270.

Somewhat similar to *Goodman* is *Borissoff v. Taylor & Faust*.<sup>749</sup> Here, the underlying tax negligence involved failing to amend a federal estate tax return to claim relatively nominal deductions that had been overlooked and also failing to keep the statute of limitations open to enable the filing of an amended return for additional administrative expenses being incurred in litigation related to which of decedent's wills was governing.<sup>750</sup> The case, however, deals solely with statute of limitations and certain other procedural issues.<sup>751</sup>

In *Allmen v. Fox Rothschild LLP*, one of the allegations was that the defendant attorneys were negligent in preparing the decedent's estate tax returns by treating certain bank and brokerage accounts of the decedent as being joint accounts rather than including the accounts as part of the estate.<sup>752</sup> Excluding these funds from the estate, together with the operation of the tax allocation clauses of the will, which were also alleged to be negligently drafted, forced the estate to pay certain debts and expenses with funds that otherwise would have gone to a charitable lead trust, thereby reducing the estate's charitable contribution deduction and increasing the estate's tax liability.<sup>753</sup> The court, however, did not focus on the substance of the claims but on statute of limitations issues.<sup>754</sup>

In *Hall v. Crittendon and Assocs. LTD*, the plaintiff taxpayers seem to have retained a tax preparer that was shady and unscrupulous.<sup>755</sup> Before 2004, the plaintiffs' tax returns were prepared by a CPA.<sup>756</sup> To save on fees, the plaintiffs decided to have their 2003 tax return prepared at an office doing business as EZ E-File.<sup>757</sup> When they met with the return preparer he told them their prior returns were not prepared correctly and that many deductions to which they were entitled were not claimed.<sup>758</sup> They not only

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<sup>749</sup> See Nos. A093450, A094395, 2006 WL 952578, at \*2 (Cal. Ct. App. Apr. 13, 2006).

<sup>750</sup> *Id.* at \*1–3. The gross estate was over \$1.8 million. The omitted deductions totaled over \$1,000. *Id.* at \*2.

<sup>751</sup> *Id.* at \*1, \*3.

<sup>752</sup> 101964/11, 2012 WL 470451, at \*1–2 (N.Y. Sup. Ct. Jan. 31, 2012). The case is discussed in somewhat more detail *infra* at text accompanying notes 1089–1094.

<sup>753</sup> *Id.* at \*2.

<sup>754</sup> *Id.* The case arose on the defendant attorney's motion to dismiss on statute of limitations grounds.

<sup>755</sup> See A133235, 2013 WL 1810593, at \*2 (Cal. Ct. App. Apr. 30, 2013).

<sup>756</sup> *Id.* at \*1.

<sup>757</sup> *Id.*

<sup>758</sup> *Id.*

had the 2003 return prepared, but also amended returns back to 1998.<sup>759</sup> The amended returns reduced the earlier reported adjusted gross income very dramatically.<sup>760</sup> The changes were obviously fabricated since the return preparer did not even request to see any business records for the prior tax years.<sup>761</sup> In June of 2004, the IRS denied the plaintiffs' refund claims for 1998–2000 on statute of limitations grounds and opted to audit the amended 2001 to 2003 tax returns.<sup>762</sup> While the defendant was retained to represent the plaintiffs on the audit, the representation was unsatisfactory.<sup>763</sup> They later learned the audit had not gone well.<sup>764</sup> Their refund claims were denied, the IRS asserted they owed over \$23,000 in additional taxes, interest and penalties for 2002 and 2003 and they could have been prosecuted for fraud.<sup>765</sup> They subsequently retained a tax attorney who favorably resolved their tax situation.<sup>766</sup> This suit against the defendants ensued.<sup>767</sup>

This suit went to trial and the plaintiffs received a judgment for over \$39,000.<sup>768</sup> On this appeal the judgment was reversed on statute of limitations grounds.<sup>769</sup> In its opinion, the court adhered to established California precedent that damages for emotional distress are not available where, such as here, the loss is purely economic.<sup>770</sup>

The following three cases are worthy of brief mention. Although each case, at some level, involves inaccurate tax returns, in each this issue is essentially engulfed and overshadowed by other concerns or issues.

*Estate of Erich Heinz* involves a contested proceeding in New York's Surrogate's Court brought by the preparer of an estate tax return in order to collect his fees.<sup>771</sup> The estate tax return involved was negligently prepared and overstated the amount of tax due.<sup>772</sup> The case, however, really revolves

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<sup>759</sup> *Id.*

<sup>760</sup> *Id.* at \*2.

<sup>761</sup> *See id.*

<sup>762</sup> *Id.*

<sup>763</sup> *Id.*

<sup>764</sup> *Id.*

<sup>765</sup> *Id.*

<sup>766</sup> *Id.*

<sup>767</sup> *Id.* at \*3.

<sup>768</sup> *Id.*

<sup>769</sup> *Id.* at \*4–5.

<sup>770</sup> *Id.* at \*6.

<sup>771</sup> 2006 N.Y. Misc. LEXIS 4230, at \*1, \*10 (Surr. Ct. Dec. 29, 2006).

<sup>772</sup> *Id.* at \*6–7.

about the astonishingly shocking activities of the preparer and will be discussed subsequently.<sup>773</sup> *Wooley v. Jackson Hewitt, Inc.*,<sup>774</sup> previously discussed,<sup>775</sup> alleged the return preparer made up deductions and thus created an inaccurate return.<sup>776</sup>

*Nathel v. Siegal* involved motions to dismiss a securities law action brought against the sellers of an allegedly fraudulent oil and gas investment scheme.<sup>777</sup> The defendants allegedly misrepresented the investments to be valid interests in oil and gas drilling partnerships that were expected to produce revenue from operations as well as certain tax deductions.<sup>778</sup> In fact, most of the wells were already dug and were dry, so the promised tax deductions were impossible to obtain.<sup>779</sup> Among the defendants were the taxpayers' accountant who vouched for the investments and other accountants who prepared certain of the partnership's tax forms which included deductions that were obviously unavailable and that were in the process of being disallowed.<sup>780</sup> The court refused to dismiss plaintiffs' declaratory judgment claims against one set of defendants solely on the ground that the damages claimed were not yet final and therefore hypothetical.<sup>781</sup> The court did dismiss the cause of action against the second set of accountants who only prepared one of the partnerships' tax returns since they were not otherwise involved in selling the fraudulent investment and any action for only tax malpractice belonged in state court, not in federal court.<sup>782</sup>

In *RTR Technologies, Inc. v. Helming*, an accountant was sued—albeit unsuccessfully—for giving correct and ethical advice.<sup>783</sup> The underlying flavor of the case is evident from the first paragraph of the district court's opinion:

The background of this case is unusual and, to some extent, disturbing. Plaintiffs managed for many years to enjoy over

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<sup>773</sup> See text accompanying notes 831–863, *infra*.

<sup>774</sup> 540 F. Supp. 2d 964 (N.D. Ill. 2008).

<sup>775</sup> See text accompanying notes 499–507, *supra*.

<sup>776</sup> *Id.* at 968.

<sup>777</sup> 592 F. Supp. 2d 452, 458 (S.D.N.Y. 2008).

<sup>778</sup> *Id.*

<sup>779</sup> *Id.* at 459.

<sup>780</sup> *Id.*

<sup>781</sup> *Id.* at 472–73.

<sup>782</sup> *Id.* at 474.

<sup>783</sup> 815 F. Supp. 2d 411, 424 (D. Mass. 2011), *aff'd*, 707 F.3d 84 (1st Cir. 2013).

\$1,000,000, tax-free, by claiming on their tax returns that this money was a “loan” from a Subchapter S corporation they controlled, rather than income. When Defendants, an accounting firm, advised them to amend the return to recognize these funds as income, Plaintiffs followed the advice and incurred a tax liability. Now Defendants find themselves sued for this allegedly negligent advice.<sup>784</sup>

RTR Technologies was a subchapter S corporation.<sup>785</sup> Its president and sole shareholder was Ms. Berger.<sup>786</sup> Evidently, from 1994 until 2003, Ms. Berger withdrew varying sums of money from RTR which were recorded as loans to officer on RTR’s books.<sup>787</sup> These loans totaled over \$1 million.<sup>788</sup> These loans drew criticism in 2002 and 2003 when RTR attempted to obtain loans from the Small Business Administration.<sup>789</sup> In 2003, the defendant and his firm were hired as a turnaround manager for RTR.<sup>790</sup> In 2005, the defendant was also retained to provide tax preparation services for RTR.<sup>791</sup> The defendant was convinced that these loans were not really loans but “surreptitious advances.”<sup>792</sup> The loans had no documentation, nor “attributes of loans,” which presumably means no interest was ever paid on the loans.<sup>793</sup> In addition, Ms. Berger did not have the means to repay these loans.<sup>794</sup> In light of this, the defendant advised Ms. Berger to amend her personal and RTR’s tax returns for 2002 to reclassify the loans as income to Ms. Berger.<sup>795</sup> After consulting with counsel, who also expressed concern about the loans, Ms. Berger reluctantly agreed to file amended returns for 2002 through 2005 for herself and RTR.<sup>796</sup> While the additional income resulted in Ms. Berger owing additional federal income tax of over

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<sup>784</sup> *Id.* at 414.

<sup>785</sup> *Id.* at 415. An S-corporation is a special type of corporation that generally is not subject to the income tax imposed on corporations. *See* IRC § 1363(a) (2012).

<sup>786</sup> 815 F. Supp. 2d at 415.

<sup>787</sup> *Id.* at 416.

<sup>788</sup> *Id.* There were also advances made to other companies owned by Ms. Berger and/or her husband. But these will be ignored in the discussion.

<sup>789</sup> *Id.*

<sup>790</sup> *Id.* at 417.

<sup>791</sup> *Id.*

<sup>792</sup> *Id.*

<sup>793</sup> *Id.*

<sup>794</sup> *Id.*

<sup>795</sup> *Id.*

<sup>796</sup> *Id.* at 418

\$525,000, the corresponding effect on RTR (additional compensation paid of over \$1 million plus other additional deductions) caused RTR to go from a small profit for these years to cumulative loss of over \$1.475 million.<sup>797</sup>

In 2008, the defendants ceased all business dealings with RTR and Ms. Berger.<sup>798</sup> Pursuant to advice from an in-house accountant for RTR, Ms. Berger then re-amended her 2002 income tax return to reverse the change made by the defendants' amended return by eliminating the \$1 million of income and resurrecting the loan to officers account.<sup>799</sup> This suit against the defendant and his accounting firm ensued asserting damages of over \$4.5 million for various purported additional costs and lost profits.<sup>800</sup>

While the court rather easily granted the defendants' motion for summary judgment on statute of limitations grounds<sup>801</sup> and could have ended its analysis with that ruling, it went on to address the plaintiffs' substantive claims and to lambast the defendants and lambast Ms. Berger.<sup>802</sup> Apparently, the court was annoyed not only with Ms. Berger's original tax evasion of treating money taken from RTR as loans, but also because the court caught the plaintiff red-handed in further tax cheating.<sup>803</sup> The court rather astutely observed that while Ms. Berger in 2008 re-amended her personal 2002 income tax return to eliminate the \$1 million in income and to re-characterize it as a loan, she never re-amended RTR's income tax returns for 2003 through 2007 to reflect the corresponding elimination of the extra \$1 million of compensation deduction created by the original amendment of the 2002 income tax returns.<sup>804</sup>

As a result, amending only the [personal] 2002 tax returns eliminated the estimated \$500,000 tax liability caused by Defendants' actions *and* allowed Plaintiffs to reap the benefits of the million-dollar loss carried forward by RTR in the years that followed. Defying logic and IRS

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<sup>797</sup> *Id.*

<sup>798</sup> *Id.* at 418–19

<sup>799</sup> *Id.* at 419.

<sup>800</sup> *Id.*

<sup>801</sup> *Id.* at 424.

<sup>802</sup> *Id.* at 424, 434. The court also lambasted the plaintiffs' attorney/CPA expert witness. The court perceived the expert's testimony that the loan need not have been re-characterized as income but could have been paid down over time as simply a ruse to snooker the IRS until the statute of limitations expired on the 2002 tax return. *Id.* at 428.

<sup>803</sup> *See id.* at 414, 434.

<sup>804</sup> *Id.* at 419.



regulations, Plaintiffs are at the present time, in essence, having their cake and eating it too—and trying to get an extra dollop of whipped cream by reaping damages from Defendants.<sup>805</sup>

The district court's annoyance with Ms. Berger, and its sympathy for the defendants, is aptly illustrated by the court's concluding paragraphs of the opinion:

It is surprising that Plaintiffs had the temerity to bring this lawsuit. The complaint was clearly filed too late. The record, mainly as a result of Plaintiffs' failure to file long-overdue tax returns, is utterly insufficient to demonstrate damages. Most importantly, it is clear that Plaintiffs for many years enjoyed over \$1,000,000 in income without paying any taxes on it, and they accomplished this by filing a tax return that improperly characterized the monies they received as a loan. It is close to ludicrous to claim that, by advising Plaintiffs to amend the 2002 tax return to conform with what the law and good accounting practice required, Defendants were being negligent. On the contrary, they were serving their clients ethically and well.

As a result of behaving professionally, Defendants have found themselves slapped with this expensive lawsuit. That undeserved headache, at least, is now over. The court can only hope that the IRS and the state authorities will make sure that Plaintiffs now proceed to do what everyone who enjoys the privilege of living in our beloved country is required to do: pay their fair share of taxes.<sup>806</sup>

The moral, perhaps, is that a plaintiff bringing this type of tax malpractice case should have clean hands as concerns tax compliance. If not, the judge may very well notice.

### *C. Taxpayer Representation Before IRS and Courts*

In contemplating possible malpractice scenarios involving tax, one of the most basic to come to mind would undoubtedly be negligent representation before the IRS or some other taxing authority or before a

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<sup>805</sup> *Id.* at 425.

<sup>806</sup> *Id.* at 434.

court. Two recent cases demonstrate these situations. A third case demonstrates an extremely unusual situation that could have come from a Hollywood script writer—probably one who specializes in horror films.

In *Sahadi v. Scheaffer*, which was previously discussed,<sup>807</sup> one of the allegations against the defendant accountant/return preparer was that he negligently represented the plaintiffs before the IRS.<sup>808</sup> In fact, the reports of the IRS agents which proposed tax deficiencies of approximately \$35 million explicitly criticized the defendant.<sup>809</sup> The reports asserted that he failed “to (1) provide information the IRS had requested, and (2) offer support for tax positions he had asserted during the audit process.”<sup>810</sup> While *Sahadi* held the suit was not barred by the statute of limitations, there is no reported case indicating the outcome of the litigation.<sup>811</sup>

*Guerrero v. McDonald* involved a claim for negligent representation in a Tax Court litigation.<sup>812</sup> During the 1990s the IRS conducted multiple audits of tax returns of corporations owned by the plaintiff and asserted additional taxes due.<sup>813</sup> The plaintiff then hired the defendant to represent him at the IRS appeals process and subsequently to file suit in Tax Court to contest the proposed adjustments.<sup>814</sup> The defendant was a CPA who had a law degree, but was not licensed to practice law in Georgia.<sup>815</sup> After losing in Tax Court, the plaintiff hired a law firm to appeal the decision.<sup>816</sup> The judgment of the Tax Court was ultimately upheld by the Eleventh Circuit.<sup>817</sup> Subsequently, the plaintiff sued the defendant, claiming that he was negligent in how he handled the trial in Tax Court.<sup>818</sup> Alternatively, the plaintiff argued that if the defendant’s initial advice that the plaintiff’s tax claims were meritorious was incorrect, then he sought to recover all fees paid to plaintiff and the other attorneys who represented him in post-trial

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<sup>807</sup> See *supra* Part III.B.2.

<sup>808</sup> 66 Cal. Rptr. 3d 517, 523–24 (Cal. Ct. App. 2007).

<sup>809</sup> *Id.* at 520–22.

<sup>810</sup> *Id.* at 522.

<sup>811</sup> *Id.* at 542–43.

<sup>812</sup> 690 S.E.2d 486, 487 (Ga. Ct. App. 2010).

<sup>813</sup> *Id.*

<sup>814</sup> *Id.*

<sup>815</sup> *Id.* at 487, n.4.

<sup>816</sup> *Id.* at 487.

<sup>817</sup> *Id.*

<sup>818</sup> *Id.*

proceedings.<sup>819</sup> The trial court granted the defendant's motion for summary judgment.<sup>820</sup>

As to the initial claim, the court held the plaintiff failed to establish a prima facie cause of action because he never established proximate causation.<sup>821</sup> The plaintiff never established that but for the defendant's negligence a different result would have been obtained.<sup>822</sup> He was simply second guessing what the defendant did.<sup>823</sup> As to the alternative cause of action, the court went back to very basic doctrine affirming the error in judgment rule.<sup>824</sup> So long as an attorney honestly exercises his judgment in the conduct of litigation, he cannot be held liable for malpractice.<sup>825</sup> Professionals are not insurers who guarantee outcomes.<sup>826</sup>

Interestingly, the lower court applied the legal malpractice standard here even though the defendant was not a licensed attorney.<sup>827</sup> The court did this because both parties cited legal malpractice precedent and neither objected to the use of such precedent.<sup>828</sup> Also, the asserted malpractice concerned actions taken in connection with a trial.<sup>829</sup> The appellate court approved the holding of the lower court and also applied the legal malpractice standard.<sup>830</sup>

*Estate of Erich Heinz* involves a situation in which the representation—or actually, misrepresentation—of the executor of an estate is so extremely diabolical, that it almost could be imagined to be the fictional creation of some horror novelist.<sup>831</sup> In *Heinz*, the decedent had property in the United States and Germany.<sup>832</sup> The estate was divided equally between his three children, one of whom, Bettina, resided in California, while the other two

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<sup>819</sup> *Id.* at 487–88.

<sup>820</sup> *Id.* at 488.

<sup>821</sup> *Id.*

<sup>822</sup> *Id.* at 488.

<sup>823</sup> *Id.* at 489.

<sup>824</sup> *Id.*; See text accompanying notes 281–282, *supra*.

<sup>825</sup> *Guerrero*, 690 S.E.2d at 489.

<sup>826</sup> *Id.*

<sup>827</sup> *Id.* at 488.

<sup>828</sup> *Id.*

<sup>829</sup> *Id.*

<sup>830</sup> *Id.* The court was careful to note that the “application was limited to the facts of this case.” *Id.* at footnote 7.

<sup>831</sup> See 2006 N.Y. Misc. LEXIS 4230, at \*1–3 (N.Y. Sur. Ct. Dec. 29, 2006).

<sup>832</sup> *Id.* at \*1.

resided overseas.<sup>833</sup> Bettina was named executor of the will and in June 1999, was duly qualified in New York.<sup>834</sup> She also received ancillary letters in Germany.<sup>835</sup> She hired Ervin Sommer to prepare the estate's federal estate tax return.<sup>836</sup> Sommer was an enrolled agent who could practice before the IRS, but was neither an attorney nor an accountant.<sup>837</sup> In connection with the retainer, Bettina executed a power of attorney and a declaration of representation in favor of Sommer.<sup>838</sup> These enabled Sommer to receive confidential financial information and to execute documents on behalf of the estate.<sup>839</sup> Sommer filed the estate's tax return in October of 1999.<sup>840</sup>

Bettina became dissatisfied with Sommer's work and revoked his power of attorney on August 24, 2000, before an IRS estate tax advisor.<sup>841</sup> Sommer was notified of the termination by phone and in writing.<sup>842</sup> Without Bettina's knowledge, Sommer contacted the IRS claiming that he still represented the estate and that his power of attorney was revoked by mistake.<sup>843</sup> He then urged the IRS to audit the estate's tax return, which it did.<sup>844</sup> He never notified Bettina of the audit.<sup>845</sup> He represented the estate on the audit and the IRS determined that additional taxes of over \$70,000 were due.<sup>846</sup> Without any authority, he then filed an amended return on behalf of the estate.<sup>847</sup> All of this occurred despite the fact that Bettina again informed the IRS that Sommer's original power of attorney was revoked and that she again informed him, by phone and in writing, that he should refrain from any contact with the IRS on behalf of the estate.<sup>848</sup> Sommer ignored

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<sup>833</sup> *Id.*

<sup>834</sup> *Id.*

<sup>835</sup> *Id.*

<sup>836</sup> *See id.* at \*1, \*3.

<sup>837</sup> *Id.* at \*1-2.

<sup>838</sup> *Id.* at \*3.

<sup>839</sup> *Id.*

<sup>840</sup> *Id.*

<sup>841</sup> *Id.*

<sup>842</sup> *Id.*

<sup>843</sup> *Id.* at \*3-4.

<sup>844</sup> *Id.* at \*4, \*5.

<sup>845</sup> *Id.* at \*4.

<sup>846</sup> *Id.* at \*5.

<sup>847</sup> *Id.*

<sup>848</sup> *Id.* at \*5-6.

Bettina's instructions and filed an amended return for the estate.<sup>849</sup> While the details of this case are not specific, some of these events occurred up to three years after the power of attorney was revoked.<sup>850</sup>

While this was transpiring, Sommer flooded the German court and Bettina's siblings with letters and documents accusing her of criminal activity and of committing numerous breaches of her fiduciary duties.<sup>851</sup> This resulted in a revocation of Bettina's ancillary letters in Germany.<sup>852</sup> She had to retain German counsel to seek reinstatement of her letters.<sup>853</sup>

In October 2003, Bettina commenced an action in California for damages and an injunction against Sommer.<sup>854</sup> The CPA she hired to review the estate's records testified that Sommer made numerous errors on the estate tax return, including failing to claim a tax credit for foreign estate taxes, failing to deduct administration expenses, and overstating the value of the German property of the estate.<sup>855</sup> A corrected tax return was filed, and a tax abatement of \$94,000 was obtained.<sup>856</sup>

While the California litigation was pending, Sommer claimed to be a creditor of the estate and filed this petition in New York Surrogate's Court seeking an accounting from Bettina.<sup>857</sup> When she failed to timely account, he brought a petition to hold her in contempt.<sup>858</sup> Upon a hearing of what essentially became a suit for fees, Sommer admitted he had no authority to act on behalf of the estate or Bettina.<sup>859</sup> He was ordered to refrain from contacting the IRS on behalf of the estate.<sup>860</sup> Without getting into similar details about his claimed fees, the court held Sommer was not entitled to recover any fees.<sup>861</sup>

At the end of the opinion, the court indicated that Sommer had recently filed complaints with the IRS against Bettina and her California attorney

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<sup>849</sup> *Id.* at \*6. It is not clear from the opinion whether he filed one or two amended returns. *See id.*

<sup>850</sup> *See id.*

<sup>851</sup> *Id.* at \*4–5.

<sup>852</sup> *Id.* at \*5.

<sup>853</sup> *Id.*

<sup>854</sup> *Id.* at \*6.

<sup>855</sup> *Id.* at \*6–7.

<sup>856</sup> *Id.* at \*6.

<sup>857</sup> *Id.* at \*7.

<sup>858</sup> *Id.* at \*8.

<sup>859</sup> *See id.* at \*8–9.

<sup>860</sup> *Id.* at \*9.

<sup>861</sup> *Id.* at \*13.

and accountant.<sup>862</sup> The little bit of light at the end of the tunnel was that a possibility of obtaining sanctions against Sommer did remain open.<sup>863</sup>

#### D. Personal Tax Planning

##### 1. Income Tax

###### a. Litigation Settlement Advice

In *Kerbein v. Hutchison*, the defendant attorney represented the plaintiff in a worker's compensation discrimination claim against her former employer.<sup>864</sup> The plaintiff agreed to settle her claim for \$37,500 based on her belief that this amount was not taxable.<sup>865</sup> At the settlement hearing, the plaintiff accepted the \$37,500 with the express condition that she had ten days to investigate the tax consequences of the settlement.<sup>866</sup> Five days later, the defendant advised the plaintiff that the \$37,500 would not be subject to tax, so she allowed the settlement to become final.<sup>867</sup> It was later determined that the \$37,500 was taxable.<sup>868</sup> The issue before the court was whether the statute of limitations had expired before this suit was instituted.<sup>869</sup> The Third Department held the statute of limitations began to run when the settlement became final and that the suit was timely.<sup>870</sup>

*Delahaye v. Plaisance* also involved an allegation that the defendant attorney incorrectly advised the plaintiff that an amount received in the settlement of litigation would not be subject to federal or state income tax.<sup>871</sup> The case, however, focuses on the statute of limitations and affirms the trial court's dismissal of the action as untimely.<sup>872</sup>

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<sup>862</sup> *Id.*

<sup>863</sup> *Id.* at \*14.

<sup>864</sup> 816 N.Y.S.2d 591, 591 (App. Div. 2006).

<sup>865</sup> *Id.*

<sup>866</sup> *Id.*

<sup>867</sup> *Id.*

<sup>868</sup> *Id.*

<sup>869</sup> *See id.* at 592.

<sup>870</sup> *Id.* at 592–93.

<sup>871</sup> No. 2007 CA 1697, 2008 WL 2065927, at \*1 (La. Ct. App. May 2, 2008).

<sup>872</sup> *See id.* at \*3. A noteworthy aspect of this case is that the plaintiff initially brought a similar action that seemed timely. *See id.* at \*1. That action was dismissed by the plaintiff because he had not yet filed his tax return and could not quantify his damages. *Id.* But inability to precisely quantify damages was held not to delay the accrual of the cause of action for statute of limitations purposes. *See id.* at \*3.

In *Ortiz v. Allyn, Hausner & Montanile, LLP*, the defendant attorney represented the plaintiff in an employment discrimination action that was settled in June 2000.<sup>873</sup> The settlement agreement failed to specify whether any of the proceeds were attributable to personal physical injuries or physical sickness.<sup>874</sup> From August 2002 until January 20, 2003, the defendant represented the plaintiff before the IRS and/or the Tax Court concerning the taxability of the proceeds.<sup>875</sup> The Tax Court ultimately ruled adversely to the plaintiff.<sup>876</sup> The plaintiff instituted this suit in December 2003, which was within three years of the defendant's representation on the tax issue, but was later than three years from the settlement of the underlying discrimination action in June 2000.<sup>877</sup> The majority of the First Department held the continuous representation doctrine applied, the suit was timely, and affirmed the lower court's denial of the defendant's motion to dismiss.<sup>878</sup>

*b. Long Term Capital Gains*

In *Flannery v. Singer Asset Finance Co.*, the ultimate error asserted involved incorrect advice by an attorney stating that if a taxpayer sold a series of anticipated annual lottery payments for a discounted lump sum payment, the lump sum would be subject to the lower tax rates imposed on long term capital gains.<sup>879</sup> The case, however, involves a much more nefarious scheme surrounding the advice.<sup>880</sup> In *Flannery*, the defendant was in the business of purchasing the installment payments of lottery winners for a lump sum amount.<sup>881</sup> The plaintiff had won an Iowa state lottery in 1988.<sup>882</sup> The defendant, on a number of occasions, had unsuccessfully attempted to purchase the plaintiff's lottery payments for a lump sum

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<sup>873</sup> 852 N.Y.S.2d 555, 555–56 (App. Term 2007).

<sup>874</sup> *Id.* at 555.

<sup>875</sup> *Id.* at 556. The exact nature of the representation is unclear. The majority opinion indicates the representation was before the IRS, but the dissent indicates the representation was before the Tax Court. *Id.*

<sup>876</sup> *Id.*

<sup>877</sup> *See id.*

<sup>878</sup> *Id.* The dissent believed the continuous representation doctrine did not apply and would have dismissed the complaint as time-barred. *Id.* at 557.

<sup>879</sup> 17 A.3d 509, 511 (Conn. App. Ct. 2011).

<sup>880</sup> *See id.*

<sup>881</sup> *Id.*

<sup>882</sup> *Id.*

price.<sup>883</sup> The defendant, it was alleged, entered into a business relationship with an attorney, whose role was to offer lottery winners purportedly “independent” advice stating that by selling their lottery payments they would gain significant tax advantages—presumably the long term capital gains tax rates.<sup>884</sup> This advice was false.<sup>885</sup> The plaintiff ended up retaining the attorney’s law firm, thereby receiving the intentionally false advice.<sup>886</sup> This suit was then instituted against the attorney, his law firm, and the defendant.<sup>887</sup> After the cause of action was dismissed against the attorney and the law firm, the lower court granted summary judgment to the defendant on statute of limitations grounds, which was affirmed by the Connecticut Appellate Court.<sup>888</sup>

In *Camico Mutual Insurance Co. v. Rogozinski*, an accounting firm had incorrectly reported long term capital gains income as ordinary royalty income for tax years from 1989 to 2006.<sup>889</sup> The ensuing extra taxes were incurred by three brothers who were partners in patents they licensed to others.<sup>890</sup> The parties in this case were the taxpayers and the accounting firm’s professional liability insurance carrier.<sup>891</sup> The issue was whether under the policy there was one claim, with a \$1 million policy limit, or several claims, with a \$2 million policy limit.<sup>892</sup> The court held there was only one claim involved.<sup>893</sup>

### c. Divorce Related

In *Fielding v. Kupferman*, the plaintiff brought a malpractice suit against the attorney who represented him in a divorce action.<sup>894</sup> In the divorce action, the defendant attorney advised the plaintiff to enter into a

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<sup>883</sup> *Id.*

<sup>884</sup> *See id.*

<sup>885</sup> *Id.*

<sup>886</sup> *Id.*

<sup>887</sup> *Id.* at 510 n.2, 512.

<sup>888</sup> *Id.* at 510 n.2, 515. The court does not disclose the reason for the dismissal of the claims against the attorney and his firm. In a footnote, the court states that they received partial summary judgment in the trial court and that the plaintiff thereafter withdrew the remaining claims against them. *See id.* at 510 n.2.

<sup>889</sup> No. 3:10-cv-762-J-32MCR, 2012 WL 4052090, at \*3-4 (M.D. Fla. Sep. 13, 2012).

<sup>890</sup> *Id.* at \*3.

<sup>891</sup> *Id.* at \*5.

<sup>892</sup> *Id.* at \*1.

<sup>893</sup> *Id.* at \*11.

<sup>894</sup> 885 N.Y.S.2d 24, 25 (App. Div. 2009).



stipulation, subsequently incorporated into the judgment of divorce, that he would pay his wife \$1.2 million in immediately available funds.<sup>895</sup> The plaintiff's total liquid assets at that time were around \$1.26 million, almost \$895,000 of which was in a Keogh account.<sup>896</sup> As assets in a Keogh retirement account, these funds were available before retirement only upon the incurrance of a substantial tax cost.<sup>897</sup> Notwithstanding the defendant's knowledge of the facts, she advised him to agree to the stipulation and never informed him of the tax costs involved in withdrawing money from the Keogh account.<sup>898</sup> After entering into the stipulation and being unable to mortgage his apartment that he still co-owned with his soon-to-be ex-wife, the plaintiff was forced to withdraw the money from the Keogh account to meet his payment obligation to his wife.<sup>899</sup> Although the lower court granted the defendant's motion to dismiss the complaint for failing to state a cause of action, the First Department unanimously reversed and reinstated the cause of action.<sup>900</sup>

*d. Offshore Trusts*

There are several cases involving the creation and utilization of offshore trusts as a tax savings device. In *DeMay v. Moore & Bruce, LLP*, the defendant attorneys and the plaintiff established an ongoing relationship in 1995.<sup>901</sup> Defendant, Bruce, became a board member of the plaintiff's corporation, DeMay, and a legal advisor to Mr. DeMay.<sup>902</sup> Defendant Moore became chief counsel for the corporation.<sup>903</sup> In 1996, the defendants advised DeMay to create four foreign trusts in order to reduce the taxes that he might incur in the event of the sale of his company.<sup>904</sup> The four trusts were established and shares of DeMay's company were transferred to the trusts.<sup>905</sup> Over the ensuing years, the defendant attorneys were extensively

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<sup>895</sup> *Id.*

<sup>896</sup> *Id.* at 27.

<sup>897</sup> *Id.*

<sup>898</sup> *Id.* at 25–26.

<sup>899</sup> *Id.* at 25.

<sup>900</sup> *Id.*

<sup>901</sup> *See* 584 F. Supp. 2d 170, 174 (D.D.C. 2008).

<sup>902</sup> *Id.*

<sup>903</sup> *Id.*

<sup>904</sup> *Id.*

<sup>905</sup> *Id.*

involved with the trusts.<sup>906</sup> Bruce was a fiduciary of all the trusts.<sup>907</sup> Moore and their law firm did legal work for the trusts.<sup>908</sup> Over the years, in addition to assisting in the operation of the trusts, they also amended the trust agreements, appointed a trustee for a trust, moved the location of one of the trusts, were involved in trust litigation, and reviewed tax returns of the trusts.<sup>909</sup>

In 1999, the IRS began an audit of DeMay's taxes for 1996 through 1998.<sup>910</sup> While other counsel was hired as primary counsel in connection with the audits and ensuing Tax Court litigation, the defendants also participated and assisted.<sup>911</sup> The IRS ultimately asserted deficiencies of over \$12 million for unpaid income taxes and penalties, as well as nearly \$3 million for gift taxes.<sup>912</sup> All of the deficiencies arose out of various transactions the defendants advised DeMay to undertake.<sup>913</sup> In 2005, DeMay settled the income tax deficiency for \$6 million.<sup>914</sup> The following year, DeMay settled his gift tax liability.<sup>915</sup> While he acknowledged gift tax liability, no immediate tax was payable since the lifetime exclusion was greater than the gift tax and offset the liability.<sup>916</sup>

This suit ensued, alleging malpractice for all of the incorrect tax advice given over the years.<sup>917</sup> Other claims were also asserted, primarily for damages due to various breaches of fiduciary duties in connection with the defendants' administration of the trusts.<sup>918</sup> The primary focus of the case was whether the statute of limitations was suspended by the continuous representation doctrine.<sup>919</sup> The court held the statute of limitations was

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<sup>906</sup> *See id.* at 175.

<sup>907</sup> *Id.*

<sup>908</sup> *Id.*

<sup>909</sup> *Id.* at 174–75.

<sup>910</sup> *Id.* at 173.

<sup>911</sup> *See id.* at 176.

<sup>912</sup> *Id.* at 177.

<sup>913</sup> *See id.* at 177–78.

<sup>914</sup> *Id.* at 178. While the court stated that DeMay agreed to pay \$6 million for past due income taxes, it went on to note the current balance at trial had grown to \$7.5 million including interest. *Id.*

<sup>915</sup> *Id.*

<sup>916</sup> *Id.*

<sup>917</sup> *See id.*

<sup>918</sup> *Id.* at 178–79.

<sup>919</sup> *Id.* at 173.

suspended, and denied the defendants' motion for summary judgment on these causes of action.<sup>920</sup>

With respect to the damages to be addressed at the jury trial, the court endorsed the general proposition that the plaintiff could recover the difference between the taxes paid (*i.e.*, the settlement amount with the IRS) and what he would have paid with correct tax advice.<sup>921</sup> Unfortunately, the court did not address the most intriguing aspect of the damages sought by the plaintiff—whether the settlement of the asserted gift tax deficiency resulted in recoverable damages—since it did reduce the plaintiff's lifetime estate and gift tax exemption, but required no immediate payment.<sup>922</sup>

*Grace v. Allen* also involved tax planning through the creation and utilization of three levels of trusts in Belize.<sup>923</sup> In 1997, the defendant attorney advised the plaintiff to establish the trusts to minimize her tax liability.<sup>924</sup> Securities were transferred to, and sold by, the middle-level trust.<sup>925</sup> While a non-resident tax return was filed for the middle trust for 1997, no tax was due since the proceeds from the sale were purportedly distributed to the third level trust—a foreign entity.<sup>926</sup> The plaintiff never reported the sale of the securities nor paid taxes on the sale, saving approximately \$556,000.<sup>927</sup> While the IRS investigated the plaintiff between 2001 and 2003 and the Department of Justice subsequently determined the Belize trust structure to be illegal, no taxing authority ever assessed any taxes, interest or penalties in connection with this transaction.<sup>928</sup> Nevertheless, the plaintiff instituted this action against the defendant attorney seeking rescission and various damages.<sup>929</sup> The lower court granted summary judgment to the defendant on the ground that the damages sought were speculative.<sup>930</sup> The appellate court affirmed, giving

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<sup>920</sup> *Id.* at 173, 181, 186.

<sup>921</sup> *Id.* at 186.

<sup>922</sup> *See id.* at 178–79.

<sup>923</sup> No. 1 CA–CV 11–0695, 2012 WL 5893493, at \*1 (Ariz. Ct. App. Nov. 23, 2012).

<sup>924</sup> *Id.*

<sup>925</sup> *Id.*

<sup>926</sup> *See id.*

<sup>927</sup> *Id.*

<sup>928</sup> *Id.*

<sup>929</sup> *Id.*

<sup>930</sup> *Id.*

short shrift to the plaintiff's argument that she would always be at risk for paying the back taxes since there was no statute of limitations.<sup>931</sup>

*e. Miscellaneous*

In *Solin v. Domino*, the plaintiff sued his insurance agent/financial advisor for professional malpractice and negligent misrepresentation.<sup>932</sup> The crux of the complaint was that the defendant understated the tax that would be incurred if the plaintiff were to cash in his annuity policy.<sup>933</sup> The plaintiff had an annuity worth approximately \$3.2 million.<sup>934</sup> The plaintiff was contemplating one of two courses of action: (1) to surrender the annuity, pay the taxes and invest the balance in a taxable account; or (2) to roll over the annuity tax-free into another annuity.<sup>935</sup> If the second option was selected, no taxes would be currently incurred, but would be deferred until the new annuity was surrendered.<sup>936</sup> Based on the defendant's advice that approximately \$200,000 of taxes would be incurred currently if option one were chosen and the annuity cashed, the plaintiff chose option one.<sup>937</sup> It was later determined that the actual tax liability was over \$600,000 rather than the advised \$200,000.<sup>938</sup> When confronted about the discrepancy, the defendant admitted that he had made a mistake.<sup>939</sup> The suit was commenced because the plaintiff asserted he would have selected the second option if he had been given accurate advice.<sup>940</sup>

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<sup>931</sup> See *id.* at \*5. Other damages sought such as for the loss in value of the securities (some appreciated after the sale) were likewise speculative and not recoverable. *Id.*

<sup>932</sup> 08 Civ. 2837 (SCR), 2009 U.S. Dist. LEXIS 51405, at \*1 (S.D.N.Y. Feb. 25, 2009). Portions of the discussion of *Solin* are taken from *NY: Balanced or Biased*, *supra* note 42, at 173–76. There were actually two plaintiffs in *Solin*; Daniel Solin, individually and as trustee of the Daniel R. Solin Trust. *Solin*, 2009 U.S. Dist. LEXIS 51405, at \*1. For ease of presentation they are treated as one plaintiff since the issues for both were identical and the court also treated them as one. See *id.* In the final footnote of the opinion, the court noted that since the plaintiff's cause of action was defective because it failed to assert any recoverable damages, the court did not need to address the defendant's alternative argument that New York law does not recognize a professional malpractice cause of action against financial advisors. *Id.* at \*11–12 n.7. The discussion herein also does not address this contention.

<sup>933</sup> See *id.* at \*1.

<sup>934</sup> *Id.*

<sup>935</sup> *Id.* at \*2. See I.R.C. § 1035 (2012).

<sup>936</sup> *Solin*, 2009 U.S. Dist. LEXIS 51405, at \*4.

<sup>937</sup> See *id.* at \*2.

<sup>938</sup> *Id.* at \*4.

<sup>939</sup> *Id.*

<sup>940</sup> *Id.*

In New York, the elements of a cause of action for attorney malpractice are negligence, proximate causation, and damages.<sup>941</sup> In *Solin*, the court dismissed the cause of action because it found the plaintiff did not establish the existence of any recoverable damages.<sup>942</sup> The taxes incurred by the plaintiff as a result of the negligent advice were held not to be recoverable for two reasons.<sup>943</sup> First, the tax liability was caused by the plaintiff's having recognized taxable gain, not because of any misrepresentation by the defendant.<sup>944</sup> And second, any recovery of taxes would put the plaintiff in a better position than he held prior to the misrepresentation, and hence were not recoverable under New York law.<sup>945</sup>

*Solin* also gave short shrift to the plaintiff's alternative argument that he ought to be able to recover as damages the difference between the taxes incurred on cashing the annuity and what he would have incurred by utilizing the other option of deferring the tax by exchanging the annuity for another annuity.<sup>946</sup> According to the court, such damages were speculative and not recoverable.<sup>947</sup> They were speculative because the amount of taxes ultimately incurred is not knowable, they will depend upon such factors as when the future tax liability will be incurred, what the plaintiff's tax rate will be at that time, and whether there will have been any changes in—perhaps even elimination of—the tax law.<sup>948</sup> The court also rejected the plaintiff's attempt to shift the speculative problem to the defendant by stating that the plaintiff was entitled to recover the full \$600,000 of taxes currently paid, and if the defendant wanted to reduce this amount by any taxes that would be saved in the future as a result of the present tax payment, the defendant had the burden of proof on this offset.<sup>949</sup> Since the defendant certainly could not prove the amount of any offset due to its inherent speculativeness, the plaintiff argued that he should be able to recover all the taxes paid currently.<sup>950</sup>

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<sup>941</sup> *Id.* at \*5–6.

<sup>942</sup> *Id.* at \*11.

<sup>943</sup> *See id.* at \*7–8.

<sup>944</sup> *Id.* For this proposition, the court relied on *Lama Holding Co. v. Smith Barney Inc.*, 668 N.E.2d 1370, 1374 (N.Y. 1996).

<sup>945</sup> *Solin*, 2009 U.S. Dist. LEXIS 51405, at \*8. For this, the court relied on *Alpert v. Shea Gould Climenko & Casey*, 559 N.Y.S.2d 312, 314–15 (App. Div. 1990).

<sup>946</sup> *See Solin*, 2009 U.S. Dist. LEXIS 51405, at \*9.

<sup>947</sup> *Id.* at \*10.

<sup>948</sup> *Id.* at \*9–10.

<sup>949</sup> *See id.* at \*10–11.

<sup>950</sup> *Id.*

While, arguably, *Solin* may have correctly followed current New York legal principles, I have argued elsewhere that the principles are misguided and that they are really fraud-damage principles that have been inappropriately transplanted into the negligence area.<sup>951</sup> In any event, if *Solin* is followed, damages in this very basic and simple scenario (let's get tax advice before doing anything) may never be recoverable, nor may damages arising from timing differences ever be recoverable in a negligence cause of action.<sup>952</sup>

## 2. Estate, Gift and GST Tax Planning

### a. *Introductory—Privity*

Generally, in situations involving claims of tax malpractice, the defense of the expiration of the pertinent statute of limitations is frequently encountered and often successfully prevents consideration of the substantive claim.<sup>953</sup> In the estate, gift, and generation skipping tax context, another defense that is also frequently encountered is lack of privity between the plaintiff and the attorney or accountant who prepared the estate plan. The professional tax advisor normally is retained by a taxpayer to prepare an estate plan which can include the preparation of wills, trusts, perhaps other documents, and may involve transfers of property. Often, any error is discovered only after the death of the taxpayer by either the fiduciary of the estate or by an heir. If strict rules of privity are followed, neither of these parties have standing to sue since they are not in privity with the attorney or accountant who rendered the advice, drafted the documents, or effectuated the property transfers.<sup>954</sup> This means the tax advisors are impervious to any responsibility for any malpractice.<sup>955</sup>

In *Belt v. Oppenheimer, Blend, Harrison & Tate, Inc.*, the Supreme Court of Texas noted that in 2006 this strict privity rule was a minority

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<sup>951</sup> See *NY: Balanced or Biased*, *supra* note 42, at 160.

<sup>952</sup> See *Tax Malpractice Damages*, *supra* note 38, at 758.

<sup>953</sup> See, e.g., *DeMay v. Moore & Bruce, LLP*, 584 F. Supp. 2d 170, 174 (D.D.C. 2008); *Flannery v. Singer Asset Fin. Co.*, 17 A.3d 509, 511 (Conn. App. Ct. 2011); *Ortiz v. Allyn, Hausner & Montanile, LLP*, 852 N.Y.S.2d 555, 556 (App. Term 2007).

<sup>954</sup> See, e.g., *Lutz v. Balch*, Nos. 06AP-247, 2006 WL 2575811, at \*1 (Ohio Ct. App. Aug. 31, 2006); *Schlegel v. Gindlesberger*, No. 05 CA 10, 2006 WL 3783537, at \*4 (Ohio Ct. App. Dec. 26, 2006); *Schlegel v. Gindlesberger*, No. 05 CA 11, 2006 WL 3783544, at \*3 (Ohio Ct. App. Dec. 26, 2006).

<sup>955</sup> See *Schlegel*, 2006 WL 3783537, at \*4; *Schlegel*, 2006 WL 3783544, at \*3.

view followed in Texas and only eight other states.<sup>956</sup> The court then reviewed and changed the position of Texas.<sup>957</sup> Upon a careful analysis of Texas precedent, and, perhaps, a bit of fancy footwork, the court held that a malpractice claim in the estate planning context survives the decedent's death and passes to the estate.<sup>958</sup> The estate's fiduciary may pursue such claims free from any lack of privity objection.<sup>959</sup> Others, such as heirs or beneficiaries, still may not assert such claims since they are not in privity with the tax practitioner.<sup>960</sup>

In *Estate of Schneider v. Finmann*, the New York Court of Appeals followed in *Belt's* footsteps and changed the New York law.<sup>961</sup> The court held that the personal representative of the estate has privity, or a relationship sufficiently approaching privity, with the estate planning attorney of the decedent to maintain a malpractice claim on behalf of the estate.<sup>962</sup> The court emphasized however, that, absent fraud, strict privity still bars any beneficiary and other third parties from asserting a claim for estate planning malpractice.<sup>963</sup>

In Ohio, in *Lutz v. Balch*, decided by the Ohio intermediate Court of Appeals for the Tenth District in August 2006, the court simply applied Ohio's strict privity rule and affirmed the dismissal of a claim asserted by the child of the decedents against the attorney who drafted the decedents' wills and trusts.<sup>964</sup> However, in *Schlegel v. Gindlesberger*, two related cases with the same name, the Ohio intermediate Court of Appeals for the Fifth District, in December 2006, also applied Ohio's strict privity rule, but the court ended both opinions with a plea to the Ohio Supreme Court to revisit this issue.<sup>965</sup> The court was very troubled by the fact that under strict privity, negligence in the estate planning area has no remedy.<sup>966</sup> On appeal,

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<sup>956</sup> 192 S.W.3d 780, 783 (Tex. 2006). The other states are Alabama, Arkansas, Maine, Maryland, Nebraska, New York, Ohio, and Virginia. *Id.* at 783 n.1.

<sup>957</sup> *See id.* at 785.

<sup>958</sup> *Id.*

<sup>959</sup> *Id.* at 787, 789.

<sup>960</sup> *See id.* at 788–89.

<sup>961</sup> 15 N.Y.3d 306, 309 (2010).

<sup>962</sup> *Id.*

<sup>963</sup> *Id.* at 310.

<sup>964</sup> Nos. 06AP-247, 2006 WL 2575811, at \*1, \*3 (Ohio Ct. App. Aug. 31, 2006).

<sup>965</sup> No. 05 CA 10, 2006 WL 3783537, at \*4 (Ohio Ct. App. Dec. 26, 2006); No. 05 CA 11, 2006 WL 3783544, at \*3 (Ohio Ct. App. Dec. 26, 2006).

<sup>966</sup> *Schlegel*, 2006 WL 3783544, at \*4; *Schlegel*, 2006 WL 3783544, at \*3.

the Ohio Supreme Court reaffirmed its adherence to the strict privity rule.<sup>967</sup> However, the majority opinion, by four members of the seven-member court, did leave open the possibility that, in an appropriate case, they might be receptive to relaxing the strict privity rule to allow the personal representative of the estate, but not the beneficiaries, to sue for malpractice.<sup>968</sup>

The concurring opinion in *Gindlesberger*, joined by three members of the Ohio Supreme Court, is quite significant.<sup>969</sup> In it, the judges indicate they would be willing to change the strict privity rule to even allow beneficiaries to sue for malpractice in the preparation of a will.<sup>970</sup> However, the facts of this case were not appropriate for making the change.<sup>971</sup> In *Gindlesberger*, the defendant attorney had prepared the decedent's will in 1986 and later prepared two codicils.<sup>972</sup> In 1990, the decedent desired to transfer a farm she owned to one of her three children, while maintaining a life estate in the farm.<sup>973</sup> The attorney drafted a deed that retained a life estate for the decedent and gave a joint life estate to the decedent's son and his wife, with the remainder going to the survivor.<sup>974</sup> It was this later transfer that the other heirs claimed was incorrect, since it took the property out of the estate while leaving the estate with insufficient assets to pay the estate taxes resulting from the transfer.<sup>975</sup> This case, therefore, according to the concurrence, did not involve any negligence in the preparation of a will but, instead, simply involved negligence "in a financial transaction independent of the will."<sup>976</sup> It was therefore not an appropriate vehicle in which to change the strict privity rule for negligence in preparing wills.<sup>977</sup> It appears that even the Ohio Supreme Court might be receptive to changing the strict privity rule if an appropriate opportunity presented itself to the court.<sup>978</sup>

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<sup>967</sup> Shoemaker v. Gindlesberger, 887 N.E.2d 1167, 1172 (Ohio 2008).

<sup>968</sup> See *id.* at 1171–72.

<sup>969</sup> See *id.* at 1172–75.

<sup>970</sup> *Id.* at 1174.

<sup>971</sup> See *id.* at 1172–73.

<sup>972</sup> *Id.* at 1168.

<sup>973</sup> *Id.*

<sup>974</sup> *Id.*

<sup>975</sup> *Id.* at 1169, 1172.

<sup>976</sup> *Id.* at 1173.

<sup>977</sup> See *id.* at 1172–73.

<sup>978</sup> See *id.* at 1174.



*b. Planning Errors*

The most general observation about the cases that have arisen in this area is that many, but not all, focus on some procedural matter and do not specify the underlying malpractice claim in any meaningful detail. In *Lutz v. Balch*, there was simply an assertion that the attorney who drafted the decedents' wills and trust was negligent by failing to minimize estate taxes.<sup>979</sup> Similarly, in *Belt v. Oppenheimer, Blend, Harrison & Tate, Inc.*, the allegation was simply that the defendant attorneys "were negligent in drafting their father's will and in advising him on asset management[.]" causing \$1.5 million in tax liability that could have been avoided.<sup>980</sup> Both of these cases focused on privity issues.<sup>981</sup> *Steffen v. Gray, Harris & Robinson, P.A.* contains a very brief, passing reference that the plaintiffs employed the defendant attorneys for estate planning purposes.<sup>982</sup> However, the case is exclusively focused on the ineffective asset protection planning done by the defendants for the plaintiff, the wife of Paul Bilzerian, a man convicted of securities fraud in 1989, and who then attempted to hide assets from the authorities.<sup>983</sup> Similarly, in *Gelof v. Prickert, Jones & Ellio, P.A.*, there is a conclusory allegation that the defendant attorneys failed to minimize generation skipping transfer taxes.<sup>984</sup> The entire opinion's focus, however, was on the jurisdictional problem of the case, having been brought in Delaware Chancery Court rather than in Delaware Superior Court.<sup>985</sup>

In the following cases focusing on privity, the underlying negligence is somewhat more determinable, but again, without nearly enough detail to justify any discussion. In *Shoemaker v. Gindlesberger*, the negligence asserted against the defendant attorney was that he failed to advise the decedent of the tax consequences of making an inter vivos transfer of a property while retaining a life estate.<sup>986</sup> This seems to suggest a violation of I.R.C. § 2036, which addresses inter vivos transfers with the retention of a life estate.<sup>987</sup> In *Estate of Schneider v. Finmann*, the asserted negligence was in advising the plaintiff, or failing to advise the plaintiff, on how to

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<sup>979</sup>Nos. 06AP-247, 2006 WL 2575811, at \*1 (Ohio Ct. App. Aug. 31, 2006).

<sup>980</sup>192 S.W.3d 780, 782 (Tex. 2006).

<sup>981</sup>*See id.*; *Lutz*, 2006 WL 2575811, at \*1.

<sup>982</sup>283 F. Supp. 2d 1272, 1276 (M.D. Fla. 2003).

<sup>983</sup>*See id.* at 1275–77.

<sup>984</sup>C.A. No. 4930-VCS, 2010 WL 759663, at \*1 (Del. Ch. Feb. 29, 2010).

<sup>985</sup>*See id.* at \*1, \*3.

<sup>986</sup>*See* 887 N.E.2d 1167, 1168–69 (Ohio 2008).

<sup>987</sup>*See* I.R.C. § 2036 (2012).

own a \$1 million life insurance policy.<sup>988</sup> Over a period of several years prior to his death, the decedent purchased the life insurance policy, transferred it to an entity of which he was the principal owner, then transferred it to another entity of which he was the principal owner, and then, in 2005, transferred it back to himself.<sup>989</sup> The policy was included in the gross estate when the decedent died in October 2006.<sup>990</sup> This would obviously implicate I.R.C. § 2042, which addresses whether life insurance is included in the gross estate.<sup>991</sup>

*Jones v. Wilt* involved a suit by the decedent's husband, who was also the executor of the decedent's estate, against the attorney who prepared the decedent's will and a trust agreement.<sup>992</sup> Among the allegations were that the attorney failed to advise the decedent to minimize estate taxes by utilizing a qualified terminable interest property ("QTIP") trust and that the tax allocation provision in the will was defective because all of the taxes were to be paid by the residuary portion of the trust (which otherwise would have gone to the plaintiff's husband), even those pertaining to property that was devised to others.<sup>993</sup> While these issues are very interesting, the case never addressed them.<sup>994</sup> There was evidence introduced by the defendant's attorney that the decedent was not concerned with whether her husband received any property.<sup>995</sup> Her primary concern was that property she received from her father went to her surviving sister.<sup>996</sup> The opinion focused solely on whether the trial court's exclusion of certain evidence offered by an expert was correct.<sup>997</sup> The court upheld the trial court's evidentiary ruling and its grant of summary judgment to the defendant.<sup>998</sup>

*Coln v. Larson* involved an expert's testimony that was not accepted by the trial court.<sup>999</sup> In *Coln*, the defendant accountant had represented the

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<sup>988</sup> See 15 N.Y.3d 306, 308 (2010).

<sup>989</sup> *Id.* at 308.

<sup>990</sup> *Id.*

<sup>991</sup> I.R.C. § 2042 (2012).

<sup>992</sup> 871 A.2d 210, 211 (Pa. Super. Ct. 2005).

<sup>993</sup> See *id.* at 212. See generally I.R.C. § 2056(b)(7) (2012).

<sup>994</sup> *Jones*, 871 A.2d at 214.

<sup>995</sup> *Id.* at 214–15.

<sup>996</sup> *Id.* at 215.

<sup>997</sup> *Id.* at 214.

<sup>998</sup> *Id.* at 215.

<sup>999</sup> \$20B186635, B190358, 2007 Cal. App. Unpub. LEXIS 9276, at \*6 (Ct. App. Nov. 19, 2007).

decedent for a number of years.<sup>1000</sup> The representation included estate planning in addition to accounting services.<sup>1001</sup> The decedent's estate plan was reasonably intricate, involving several living trusts and a conservatorship for the decedent.<sup>1002</sup> The plaintiff, who was one of the decedent's two children and an heir of the decedent, in the spring of 2001, became convinced that utilization of a family limited partnership ("FLP") would minimize estate taxes upon his father's death.<sup>1003</sup> Although the father's conservator, who was the plaintiff's brother, initially did not agree with this, he subsequently changed his mind.<sup>1004</sup> On September 9, 2001, before the living trust could be amended to permit the creation of an FLP, the decedent died.<sup>1005</sup> The plaintiff then instituted a civil suit against the defendant accountant for negligence and breach of fiduciary duties for failing to advise the decedent to create an FLP.<sup>1006</sup> The plaintiff also instituted a similar action in the probate court.<sup>1007</sup> The defendant prevailed in both litigations.<sup>1008</sup> In the civil action, a jury found he did not act negligently, and the probate court held he did not breach any fiduciary duties.<sup>1009</sup> On this appeal, the only issue before the court was whether the plaintiff's expert witness, who was an attorney with substantial experience in estate planning, was qualified to testify as to the standards of the accounting profession that applied to the defendant accountant.<sup>1010</sup> The court affirmed the trial court's exclusion of the expert's testimony.<sup>1011</sup>

In *Jeanes v. Bank of America, N.A.*, the decedent was rather wealthy, having a gross estate of almost \$39.5 million at her death in 2003.<sup>1012</sup> Her estate paid estate and inheritance taxes equal to approximately half of the

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<sup>1000</sup> *See id.* at \*3.

<sup>1001</sup> *Id.* at \*3–4.

<sup>1002</sup> *Id.* at \*4.

<sup>1003</sup> *Id.* at \*5.

<sup>1004</sup> *Id.* at \*5–6.

<sup>1005</sup> *Id.* at \*6.

<sup>1006</sup> *Id.* at \*1, \*6.

<sup>1007</sup> *Id.* at \*1.

<sup>1008</sup> *See id.* at \*1–2.

<sup>1009</sup> *Id.*

<sup>1010</sup> *Id.* at \*6.

<sup>1011</sup> *Id.* at \*24.

<sup>1012</sup> 191 P.3d 325, 329 (Kan. Ct. App. 2008), *aff'd*, 295 P.3d 1045 (Kan. 2013).

estate.<sup>1013</sup> The primary negligence asserted was that the defendants failed to minimize the decedent's taxes.<sup>1014</sup> The plaintiff alleged that creating a family limited partnership would have saved the estate over \$6 million in taxes.<sup>1015</sup> The defendants were the bank, the bank's officer assigned to the decedent's account, and the attorney who had prepared the decedent's will, living trust, unitrust, and amendments thereto.<sup>1016</sup> The bank was the trustee of several small unitrusts of the decedent, the successor trustee of the decedent's living trust, and acted as the decedent's agent for much of her financial dealings.<sup>1017</sup> The plaintiff asserted claims of negligence, breach of contract and fiduciary duty against all defendants and also breach of trust against the bank.<sup>1018</sup> Interestingly, the plaintiff, who was the decedent's niece and inherited the majority of the decedent's assets, did not sue in her own capacity, but solely as the estate's representative.<sup>1019</sup>

The trial court below granted summary judgment on all claims to all defendants.<sup>1020</sup> With respect to the attorney defendant, the Kansas appellate court initially held that the plaintiff's claim sounded only in tort, and not as a separate breach of contract claim, since there was no specific term of any contract the attorney was alleged to have violated.<sup>1021</sup> Instead, the alleged failing by the attorney was grounded in the law's general imposition of a duty upon attorneys to use reasonable and ordinary care, diligence, and skill ordinarily possessed by attorneys in the community.<sup>1022</sup> It therefore affirmed the lower court's grant of summary judgment to the defendant attorney on the breach of contract claim.<sup>1023</sup>

As to the tort claim of negligence against the attorney, the court also affirmed the lower court's grant of summary judgment to the defendant

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<sup>1013</sup> *Jeanes*, 191 P.3d at 329. According to the facts in the Supreme Court of Kansas opinion, the taxes appear to be approximately fifty-five percent of the gross estate. *See Jeanes*, 295 P.3d at 1047.

<sup>1014</sup> *Jeanes*, 191 P.3d at 329.

<sup>1015</sup> *Id.*

<sup>1016</sup> *Id.* at 328–29. The defendants also included the predecessor bank that originally had the relationship with the decedent that was later taken over by Bank of America. *Id.* at 328.

<sup>1017</sup> *Id.*

<sup>1018</sup> *Id.* at 329.

<sup>1019</sup> *Id.* at 328–29.

<sup>1020</sup> *Id.* at 329.

<sup>1021</sup> *Id.* at 331.

<sup>1022</sup> *Id.*

<sup>1023</sup> *Id.*

attorney.<sup>1024</sup> Under Kansas law, for a tort cause of action to survive the death of a decedent, it is necessary that the cause of action accrue while the decedent was still alive.<sup>1025</sup> For a legal malpractice cause of action to accrue, the plaintiff must have suffered actual loss or damage.<sup>1026</sup> Here, the appellate court affirmed the trial court and held the damages claimed—the additional taxes incurred—arose only after the death of the decedent and therefore the claim did not survive the death of the decedent.<sup>1027</sup> In reaching this conclusion, the Court did not accept the plaintiff's argument that the decedent could have sued the attorney during her lifetime and recovered the fees paid to the defendant and the costs incurred to restructure her estate plan.<sup>1028</sup> The direct result of the Court's holding would seem to be that damages for tax malpractice in connection with wills or estate planning may never be recoverable by a decedent's estate in Kansas. However, the Court did note that in Kansas beneficiaries can sue attorneys, so attorneys might still be held responsible for such malpractice.<sup>1029</sup> This raises the question of why the plaintiff did not bring this action also on her own behalf, as the primary heir of the decedent, rather than solely as the representative of the estate. As to the trial court's award of summary judgment to the defendant bank's officer, the Kansas appellate court reversed in part, holding there were several factual issues concerning the scope of the fiduciary duties that needed to be developed at trial.<sup>1030</sup>

In *Hodge v. Cichon*, five years before his death, the decedent consulted with a tax and estate planning specialist, Frank Yong, for estate planning advice.<sup>1031</sup> Mr. Yong advised creating a family limited partnership and prepared documents to implement his suggestion.<sup>1032</sup> The decedent was later declared partially incompetent, and three individuals were appointed as his guardians.<sup>1033</sup> At the request of the guardians, the probate court entered an order directing the implementation of Mr. Yong's estate plan to reduce the

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<sup>1024</sup> *Id.* at 337. This portion of the appellate court's holding was affirmed on appeal. *Jeanes v. Bank of Am., N.A.*, 295 P.3d 1045, 1053 (Kan. 2013).

<sup>1025</sup> *Jeanes*, 191 P.3d at 337.

<sup>1026</sup> *Id.* at 331–32, 137.

<sup>1027</sup> *Id.* at 337.

<sup>1028</sup> *Id.* at 333–34.

<sup>1029</sup> *Id.* at 334.

<sup>1030</sup> *Id.* at 340.

<sup>1031</sup> 78 So. 3d 719, 720–21 (Fla. Dist. Ct. App. 2012).

<sup>1032</sup> *Id.* at 721.

<sup>1033</sup> *Id.*

estate's tax liability.<sup>1034</sup> This plan was still not fully implemented when the decedent died two and one-half years later.<sup>1035</sup> The plaintiffs, alleging they were intended beneficiaries of the decedent's estate, brought this action against the guardians' attorneys seeking to recover the loss caused by the higher estate taxes.<sup>1036</sup> The trial court below granted summary judgment to the defendant attorneys on two grounds: (1) that the plaintiffs were not intended beneficiaries and therefore lacked standing to assert this cause of action; and (2) that the family limited partnership was not viable in the current situation.<sup>1037</sup> The Florida appellate court reversed on both grounds, holding that there were factual issues that needed to be determined at trial and that summary judgment was not appropriate.<sup>1038</sup>

In *Driftmeyer v. Carlton*, the deceased was one of four partners in a successful business.<sup>1039</sup> The business had a pension plan that was funded with annuities and insurance policies.<sup>1040</sup> The plan was arranged so that insurance proceeds payable upon the death of a partner could avoid being included in the partner's gross estate, but only if the partner had created an intervivos trust to receive the insurance proceeds.<sup>1041</sup> The decedent had not created the intervivos trust, so the insurance proceeds paid upon his death (\$2 million) were paid to his estate, and therefore subject to estate taxes.<sup>1042</sup> The plaintiff, the decedent's sister and heir, as personal representative of the estate, sued everyone in sight, claiming they breached their fiduciary duty to explain to the decedent the importance of creating the intervivos trust to receive the insurance proceeds at death.<sup>1043</sup> The defendants included the accountant who originally suggested the business establish a pension plan, the insurance agent who designed and sold the plan to the business, the insurance company who sold the insurance policies, the attorney for the business who had reviewed the pension plan before it was adopted, and a number of others.<sup>1044</sup> Unfortunately for the plaintiff, the evidence established that the decedent had been informed of the need to create the

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<sup>1034</sup> *Id.*

<sup>1035</sup> *Id.*

<sup>1036</sup> *Id.*

<sup>1037</sup> *Id.*

<sup>1038</sup> *Id.* at 723.

<sup>1039</sup> No. L-06-1029, 2007 WL 1229305, at \*1 (Ohio Ct. App. Apr. 27, 2007).

<sup>1040</sup> *Id.* at \*2.

<sup>1041</sup> *Id.*

<sup>1042</sup> *See id.* at \*2, \*5.

<sup>1043</sup> *Id.* at \*2.

<sup>1044</sup> *Id.*

intervivos trust by several of the defendants.<sup>1045</sup> The evidence also established that the decedent did not really care for the life insurance feature of the plan and that he was “somewhat flippant” about the need to establish the intervivos trust.<sup>1046</sup> The Ohio appellate court therefore affirmed the trial court’s grant of summary judgment to the defendants, dismissing the complaint.<sup>1047</sup>

*c. Drafting Errors*

Under I.R.C. section 2041(a)(2), if a person has a general power of appointment at death, the property subject to the power is included in that person’s gross estate for estate tax purposes.<sup>1048</sup> A general power of appointment includes a power exercisable in favor of the decedent, but does not include any power limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent.<sup>1049</sup> The pertinent regulations provide that a power to use property for the welfare of the holder is not limited by an ascertainable standard.<sup>1050</sup>

In *Carlson v. Sweeney, Dabagia, Donoghue, Thorne, Janes & Pagos*, the elder Carlsons, in 1988, retained the defendant attorneys to prepare their wills.<sup>1051</sup> One of their goals was to avoid any additional federal and state estate taxes when the property was transferred from their children to their grandchildren.<sup>1052</sup> The wills were identical and provided that upon the death of Mr. or Mrs. Carlson, their property would go into a trust, with a bank acting as trustee.<sup>1053</sup> The income from the trust initially was payable to the surviving spouse.<sup>1054</sup> Upon the death of the surviving spouse, the income was payable to their son and daughter-in-law or the survivor.<sup>1055</sup> Upon the death of the survivor, the property would pass to their grandchildren.<sup>1056</sup>

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<sup>1045</sup> *Id.* at \*2.

<sup>1046</sup> *Id.* at \*5.

<sup>1047</sup> *Id.* at \*16.

<sup>1048</sup> I.R.C. § 2041(a)(2) (2012).

<sup>1049</sup> I.R.C. § 2041(b)(1) (2012).

<sup>1050</sup> Treas. Reg. § 20.2041-1(c)(2) (as amended in 1961).

<sup>1051</sup> 868 N.E.2d 4, 4 (Ind. Ct. App. 2007), *vacated*, 895 N.E.2d 1191 (Ind. 2008).

<sup>1052</sup> *Carlson v. Sweeney, Dabagia, Donoghue, Thorne, Janes & Pagos*, 895 N.E.2d 1191, 1193 (Ind. 2008).

<sup>1053</sup> *Id.*

<sup>1054</sup> *Id.*

<sup>1055</sup> *Id.*

<sup>1056</sup> *Id.*

The trustee had the power to invade principal for the son and daughter-in-law “as the Trustee deems necessary or advisable . . . for either of their medical care, comfortable maintenance and welfare . . . .”<sup>1057</sup> The trust also contained a provision giving a majority of the current income beneficiaries the power to remove the trustee for any reason and to appoint “any person” as the successor trustee.<sup>1058</sup> Upon the death of testators’ son or daughter-in-law, the survivor would be the sole remaining income beneficiary, and hence, would constitute a majority of the current income beneficiaries.<sup>1059</sup> As such, the survivor would have the power to remove the current trustee and appoint him or herself as trustee.<sup>1060</sup> In turn, as trustee, the survivor would have the power to invade the trust’s principal for the survivor’s own “welfare,” a discretionary, not ascertainable, standard.<sup>1061</sup> This power would require the entire corpus to be included in the survivor’s gross estate since the survivor possessed a general power of appointment.<sup>1062</sup>

In *Carlson*, both Mr. and Mrs. Carlson died in 1992.<sup>1063</sup> In 1994, an attorney retained to assist with the management of the elder Carlsons’ trust brought this problem to the attention of the Carlsons’ son.<sup>1064</sup> At the request of the beneficiaries under the elder Carlsons’ wills, the defendants brought an action to reform the trust to eliminate the problematic language.<sup>1065</sup> The trial court granted the petition to reform the trust.<sup>1066</sup> The original language was reformed to eliminate the ability of the trustee to invade principal for the “welfare” of the beneficiaries.<sup>1067</sup> The new language provided that the principal could be invaded if the trustee deems it necessary “for either of

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<sup>1057</sup> *Id.*

<sup>1058</sup> *Carlson v. Sweeney, Dabagia, Donoghue, Thorne, Janes & Pagos*, 868 N.E.2d 4, 10 (Ind. Ct. App. 2007), *vacated*, 895 N.E.2d 1191 (Ind. 2008).

<sup>1059</sup> *Id.* at 12.

<sup>1060</sup> *Id.*

<sup>1061</sup> *Id.*

<sup>1062</sup> *Id.* See also Treas. Reg. § 20.2041-1(b)(1) (as amended in 1961):

If under the terms of a trust instrument, the trustee . . . has the power to appoint the principal of the trust for the benefit of . . . himself, and the decedent has the unrestricted power to remove or discharge the trustee at any time and appoint . . . himself, the decedent is considered as having a power of appointment.

<sup>1063</sup> *Carlson v. Sweeney, Dabagia, Donoghue, Thorne, Janes & Pagos*, 895 N.E.2d 1191, 1193 (Ind. 2008).

<sup>1064</sup> *Id.* at 1193–94.

<sup>1065</sup> *Id.* at 1194.

<sup>1066</sup> *Id.*

<sup>1067</sup> See *id.*



their health and maintenance.”<sup>1068</sup> This suit was thereafter brought by the beneficiaries of the elder Carlsons against the defendants, alleging malpractice in the drafting of the wills.<sup>1069</sup>

In the trial court, the defendant attorneys were granted summary judgment on the ground that the reformation of the trust eliminated the malpractice.<sup>1070</sup> The intermediate court reversed, holding the reformation of the trust was contrary to Indiana law.<sup>1071</sup> The intermediate court also noted that for federal tax purposes, the decision of a state’s trial court is in any event not binding, so the possibility of a second estate tax upon the passage of the property to the elder Carlsons’ grandchildren was not eliminated.<sup>1072</sup> The Supreme Court of Indiana held the reformation of the trust was valid since they held avoiding adverse tax consequences was one of the main purposes of the testators.<sup>1073</sup> The Court seems to have broken new ground in holding that reformation of testamentary trusts was also available to correct for a mistake of law, not just a mistake of fact.<sup>1074</sup> Although upholding the validity of the reformation, the Supreme Court reversed the summary judgment awarded the defendant attorneys for two reasons.<sup>1075</sup> First, if the defendants were negligent, the costs incurred by the plaintiffs in addressing the original drafting error may be recoverable damages regardless of whether additional estate taxes are incurred.<sup>1076</sup> Also, although the Court was certain that its decision upholding the reformation of the trust was binding on the IRS since it was the highest court in Indiana, it was still uncertain whether the IRS might nevertheless attempt to avoid the effect of the reformation, and the Court refused to speculate on this point.<sup>1077</sup>

In *Pace v. Raisman & Assocs., Esqs.*, the defendant attorney amended a trust in 2001.<sup>1078</sup> He assured the plaintiff’s decedent that any property in the

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<sup>1068</sup> *Id.*

<sup>1069</sup> *Id.* at 1195.

<sup>1070</sup> *Id.*

<sup>1071</sup> *Id.* at 1198.

<sup>1072</sup> *Carlson v. Sweeney, Dabagia, Donoghue, Thorne, Janes & Pagos*, 868 N.E.2d 4, 17 (Ind. Ct. App. 2007), *vacated*, 895 N.E.2d 1191 (Ind. 2008).

<sup>1073</sup> *See Carlson*, 895 N.E.2d at 1199.

<sup>1074</sup> *Id.* at 1199–1201.

<sup>1075</sup> *Id.* at 1201.

<sup>1076</sup> *Id.*

<sup>1077</sup> *Id.* It is interesting to note that the court suggested the parties attempt to obtain a private letter ruling on this latter issue. *Id.* at 1201 n.11.

<sup>1078</sup> 945 N.Y.S.2d 118, 120 (App. Div. 2012).

trust at the decedent's death would not be included in his gross estate.<sup>1079</sup> It was later determined that the amendment provided the decedent with too much authority to borrow trust corpus or income without adequate consideration, and all property conveyed to the trust after the amendment was includible in the decedent's gross estate.<sup>1080</sup> The Appellate Court held the suit was not timely filed and reversed the lower court's denial of the defendant's motion to dismiss.<sup>1081</sup>

Although deciding only the procedural issue to remand a litigation back to Pennsylvania state courts, the asserted negligence in *Booth v. Baldwin* also concerned the defective drafting of a trust.<sup>1082</sup> In *Booth*, the defendant attorney drafted an irrevocable trust as part of the estate planning for the plaintiff.<sup>1083</sup> After the death of the attorney, the plaintiff retained a new attorney and accountants.<sup>1084</sup> After reviewing the trust, they informed the plaintiff that the trust was a revocable trust and the property that had been gifted to the trust would be included in his gross estate.<sup>1085</sup> The plaintiff then obtained a local court order changing the trust language.<sup>1086</sup> The IRS refused to issue a private letter ruling accepting the change.<sup>1087</sup> The plaintiff then instituted this action seeking damages for the anticipated additional taxes to be incurred and the cost of correcting the defendant's negligent drafting.<sup>1088</sup>

In *Allmen v. Fox Rothschild LLP*, the plaintiffs alleged the defendant attorneys were negligent both in drafting the tax allocation clauses in the decedent's will and subsequently in preparing the estate's federal and state estate tax returns.<sup>1089</sup> Allegedly, certain bank and brokerage accounts owned by the decedent were reported by the defendants as joint accounts on the estate tax returns, rather than as part of the estate.<sup>1090</sup> As a result, the funds in these accounts could not be used to pay debts and expenses of the

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<sup>1079</sup> *Id.*

<sup>1080</sup> *Id.*

<sup>1081</sup> *Id.* at 121.

<sup>1082</sup> No. 2:09-cv-1361, 2009 WL 3756676, at \*1 (W.D. Pa. Nov. 9, 2009).

<sup>1083</sup> *Id.*

<sup>1084</sup> *Id.*

<sup>1085</sup> *Id.*

<sup>1086</sup> *Id.*

<sup>1087</sup> *Id.*

<sup>1088</sup> *Id.*

<sup>1089</sup> 101964/11, 2012 WL 470451, at \*1 (N.Y. Sup. Ct. 2012).

<sup>1090</sup> *Id.* at \*1–2.

estate.<sup>1091</sup> Instead, funds that otherwise would have gone to a charitable lead trust were utilized to pay the debts and expenses, thereby reducing the estate's charitable tax deduction.<sup>1092</sup> The case, however, addressed only the defendants' motion to dismiss, not the substance of the claim.<sup>1093</sup> The court held that the statute of limitations had expired regarding work done by the defendant attorneys on drafting the decedent's will, but was still open on work done in connection with filing the estate's tax returns.<sup>1094</sup>

### *E. Business Related Tax Planning*

#### 1. Benefit Plans

In the employee benefit area, the tax benefit that is normally obtained by utilizing a qualified plan is for the employer to be able to obtain a current deduction for amounts spent to provide some type of future benefits to employees. The employees are taxed in the future as the benefits are received. To achieve this tax magic of an immediate deduction coupled with future income recognition, the I.R.C. normally requires a trust be utilized as an intermediary. The employer pays the cost currently to the trust, thus putting the money beyond its control. The trust then has the obligation to invest, maintain and manage the funds to enable it to provide the benefits promised the employees.<sup>1095</sup> As an overlay in this area, there are a number of requirements imposed by ERISA<sup>1096</sup> designed to assure the safety of the funds and the fairness of the benefits and procedures. As a result, in this area many professionals are involved in addition to the attorney (or benefit consultant) who drafts (and updates) the original plan and the accountant who prepares the annual tax return. A plan administrator, actuary, custodian of assets, insurance company, and various other consultants are often encountered. It should be noted that some of these individuals, as well as the promoters, financial planners and other consultants may not be

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<sup>1091</sup> *Id.* at \*2.

<sup>1092</sup> *Id.* The court noted that the reduction of the estate's charitable contribution deduction further increased the estate's taxes, thereby necessitating the use of funds that otherwise would have gone to the charitable lead trust, thereby further reducing the charitable deduction. *Id.*

<sup>1093</sup> *Id.* at \*1.

<sup>1094</sup> *Id.* at \*4.

<sup>1095</sup> See generally, Finston and Jewett, 351-5<sup>th</sup> T.M., *Plan Qualification—Pension and Profit – Sharing Plans* at A-1 to A-3.

<sup>1096</sup> *Id.* at A-1.

“professionals” under the tort or other laws of a particular state.<sup>1097</sup> One of the tax policy concerns in the benefit area is to assure that the benefit plan or arrangement actually benefits a broad range of employees, not just the owners.<sup>1098</sup>

Although all the cases examined in this section involve some type of benefit plan connection, in several of the cases the underlying facts are rather sparse or not clearly presented. For instance, *Gertler, M.D., P.C. v. Sol Masch & Co.* discloses only that the malpractice alleged against an accounting firm involved trading securities on margin within a pension plan trust.<sup>1099</sup> No additional details are offered.<sup>1100</sup> The case affirms the trial court’s dismissal of the action upon the defendant’s motion for a directed verdict due to insufficient evidence presented by the plaintiff.<sup>1101</sup> The court did note summarily that under New York law, taxes and interest on underpaid taxes are not recoverable as damages.<sup>1102</sup> Similarly, at the heart of the cause of action in *Trico Bancshares & Subsidiaries v. Rothgerber Johnson & Lyons LLP* is the claim the plaintiffs incurred \$440,000 in additional federal and California income taxes because the defendant law firm drafted a defective stock option plan for the plaintiffs.<sup>1103</sup> However, the case never mentions or cites any relevant income tax provision.<sup>1104</sup> Instead, the focus is on the fact the defendant law firm was retained “to handle all phases of SEC compliance” for plaintiffs.<sup>1105</sup> The case mostly addresses, and denies, defendant’s motion to change venue.<sup>1106</sup>

In *Schafer v. Johanson*, the malpractice asserted occurred in connection with the creation and operation of an employee stock ownership plan (“ESOP”).<sup>1107</sup> However, there are so many different allegations of fault against the attorneys and law firm that drafted the plan, and against a number of others involved with the establishment and/or operation of the plan over several years, that the precise nature of the malpractice and,

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<sup>1097</sup> *Id.*

<sup>1098</sup> *Id.* at A-18.

<sup>1099</sup> 835 N.Y.S.2d 178, 179 (App. Div. 2007).

<sup>1100</sup> *See id.*

<sup>1101</sup> *Id.* at 178–79.

<sup>1102</sup> *Id.* at 179.

<sup>1103</sup> No. 2:09-CV-01700 GEB JFM, 2009 WL 3365855, at \*1 (E.D. Cal. Oct. 15, 2009).

<sup>1104</sup> *See id.* at \*1–4.

<sup>1105</sup> *Id.* at \*1, \*3.

<sup>1106</sup> *Id.* at \*3–4.

<sup>1107</sup> No. 09-10349-BC, 2009 WL 2496943, at \*1 (E.D. Mich. Aug. 17, 2009).

perhaps, fraud is difficult to fathom.<sup>1108</sup> Boiled down to its essence, it seems the defendant attorneys convinced the plaintiffs to establish the ESOP.<sup>1109</sup> The individual plaintiffs also attempted to utilize I.R.C. section 1042 which permits the sale of shares of stock in the employer corporation sponsoring the ESOP to the ESOP without immediate recognition of gain by the sellers if a number of conditions are met.<sup>1110</sup> One of these conditions is the requirement to purchase qualified replacement property with the proceeds of the sale of the employer stock to the ESOP.<sup>1111</sup> The attorneys were apparently orchestrating all of the required activities.<sup>1112</sup> They also instructed plaintiffs to deal with various parties the attorneys selected.<sup>1113</sup> The attorneys apparently also represented the plaintiffs in connection with IRS filings, IRS challenges to the efficacy of the ESOP, and compliance with I.R.C. section 1042.<sup>1114</sup> There were also allegations of money being wasted or stolen and attorney conflicts of interest.<sup>1115</sup> In addition, there is some issue of whether the attorney defendants were representing only the corporate plaintiffs or the individual plaintiffs also.<sup>1116</sup> The bulk of the court's opinion focused on whether the dispute was subject to arbitration.<sup>1117</sup> The court denied motions by the plaintiffs and the defendants concerning arbitration and sent the case back for additional discovery to clarify the facts.<sup>1118</sup> The court also seems to have been unable to unravel the precise nature of the dispute from the confused pleadings.<sup>1119</sup>

Both *Vig v. Indianapolis Life Insurance Co.* and *Finderne Management Co. v. Barrett* involved invalid welfare benefit plans under I.R.C. section

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<sup>1108</sup> *Id.* at \*1–2.

<sup>1109</sup> *See id.* at \*2.

<sup>1110</sup> *See id.* at \*1; I.R.C. § 1042 (2012).

<sup>1111</sup> *See Schafer*, 2009 WL 2496943, at \*1; I.R.C. § 1042(a)(2) (2012).

<sup>1112</sup> *See Schafer*, 2009 WL 2496943, at \*2.

<sup>1113</sup> *Id.* at \*5.

<sup>1114</sup> *Id.*

<sup>1115</sup> *Id.* at \*6.

<sup>1116</sup> *Id.* at \*8.

<sup>1117</sup> The defendant attorneys and law firms moved to dismiss the action or compel arbitration. *Id.* at \*1. There was also a motion to dismiss another defendant. *Id.* at \*1, \*12.

<sup>1118</sup> *Id.* at \*12.

<sup>1119</sup> “At this juncture, the structure of the transactions and the portions of the transactions, conduct or advice challenged by Plaintiffs is sufficiently vague such that the court is unable to determine the scope of the arbitration agreements entered by the corporations of which the Plaintiffs were shareholders or entered by Plaintiffs themselves and whether Plaintiffs’ claims fall within the scope of the arbitration agreement.” *Id.* at \*11.

419 (e)(1).<sup>1120</sup> Although *Vig* does not explore the underlying facts in nearly as much detail as *Finderne*, it seems very likely that in both the basic flaws with the plans were quite similar. In both cases the plaintiffs were convinced to adopt and participate in section 419(e)(1) welfare benefit plans.<sup>1121</sup> The major benefit was that these plans provided an immediate tax deduction for the annual contributions, while benefits would be taxed later, when received.<sup>1122</sup> In *Finderne* the plan covered only the two brothers who operated the trucking businesses involved and their sister.<sup>1123</sup> While the sister received some group term insurance under the plan, only the brothers would be able to convert their insurance to receive retirement benefits at age sixty-five.<sup>1124</sup> In addition, the court indicated that the annual premiums paid were inflated so as to have a larger benefit at retirement.<sup>1125</sup> In effect, there was no real welfare plan for employees, just a scheme to enable the primary business owners to purchase retirement benefits and currently deduct the premiums.<sup>1126</sup>

In *Vig* the plaintiffs invested \$150,000 in the benefit plan, known as the Xelan 419 Welfare Benefit Trust, on the understanding that the plan was a legitimate tax shelter, rather than an improper tax avoidance scheme.<sup>1127</sup> When new IRS regulations were promulgated and it became obvious the plan was invalid, the plan was terminated.<sup>1128</sup> The plaintiffs lost virtually their entire investment in the plan (\$143,000) and they expected to owe additional taxes, interest and penalties to the IRS.<sup>1129</sup> They brought this action to recover these amounts.<sup>1130</sup> Since the Xelan Plan was in bankruptcy, they did not sue the Plan.<sup>1131</sup> They sued the person who was the plan's chairman, founder and trustee, the insurance company that marketed the plan and provided the plan's insurance policy, the insurance company's agent and the attorneys who, on behalf of the other defendants, provided a

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<sup>1120</sup> *Vig*, 336 B.R. 279, 280 (S.D. Miss. 2005); *Finderne*, 955 A.2d 940, 940 (N.J. Super. Ct. App. Div. 2008); I.R.C. § 419(e)(1) (2012).

<sup>1121</sup> *Vig*, 336 B.R. at 280–81; *Finderne*, 955 A.2d at 946.

<sup>1122</sup> *Vig*, 336 B.R. at 282; *Finderne*, 955 A.2d at 946.

<sup>1123</sup> *Finderne*, 955 A.2d at 946 n.2.

<sup>1124</sup> *Id.*

<sup>1125</sup> *Id.* at 946.

<sup>1126</sup> *See id.*

<sup>1127</sup> *Vig*, 336 B.R. at 280–81.

<sup>1128</sup> *Id.* at 281.

<sup>1129</sup> *Id.*

<sup>1130</sup> *Id.*

<sup>1131</sup> *Id.*

legal opinion that the plan was a valid section 419 welfare benefit plan.<sup>1132</sup> Unfortunately, *Vig* did not address the merits of the claim, but only decided the case would be remanded to state court.<sup>1133</sup>

Although differing in a number of details,<sup>1134</sup> the basic claim in *Finderne* is the same as in *Vig*. The plaintiffs were convinced they were obtaining a legitimate tax shelter in the form of a valid section 419 welfare plan, here known as an “EPIC” plan, when, in reality, the plan was invalid.<sup>1135</sup> The plaintiffs adopted the plan in 1991 and participated in it for six years, contributing over \$336,000 to the plan.<sup>1136</sup> The plan was later challenged by the IRS, and the plaintiffs were audited for 1994 and 1995.<sup>1137</sup> As a result of the audit, the plaintiffs paid additional taxes and interest of approximately \$50,000 for these two years.<sup>1138</sup> The IRS waived penalties and did not seek additional taxes for the prior four years.<sup>1139</sup> The plaintiffs also had to terminate their participation in the plan.<sup>1140</sup> They lost most of their investment in the plan because the plan’s insurance policies lapsed.<sup>1141</sup> The plaintiffs subsequently brought suit against all the parties involved with the plan and against the two financial planners who convinced them to adopt the plan.<sup>1142</sup> After a jury trial, the plaintiffs were awarded damages of almost \$37,000 from each of the financial planners.<sup>1143</sup>

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<sup>1132</sup> *Id.*

<sup>1133</sup> *Id.* at 286.

<sup>1134</sup> The *Finderne* court very meticulously presents the relevant tax provisions. *Finderne Mgmt. Co. v. Barrett*, 955 A.2d 940, 948–49 (N.J. Super. Ct. App. Div. 2008). The primary difference from the plan in *Vig* is that the EPIC plan was promoted as being a valid multiple employer plan pursuant to I.R.C. § 419A(f)(6). *Id.* at 948. As such, some of the funding restrictions on single employer plans were not applicable. *Id.* However, the plan did not qualify as a valid multiple employer plan. *Id.* at 949.

<sup>1135</sup> *Id.* at 948–49.

<sup>1136</sup> *Id.* at 946.

<sup>1137</sup> *Id.* at 947.

<sup>1138</sup> *Id.*

<sup>1139</sup> *Id.*

<sup>1140</sup> *Id.*

<sup>1141</sup> *Id.*

<sup>1142</sup> One of the financial planners, Barrett, was the plaintiffs’ financial advisor and insurance salesman since 1977. *Id.* at 945. The other advisor, Papetti, was also a CPA. *Id.* at 953. However, the court indicated that he was being sued only in his role of financial planner and not as a CPA. *Id.*

<sup>1143</sup> *Id.* at 947.

*Finderne* is the appeal by both plaintiffs and defendants from the trial judgment.<sup>1144</sup>

In addition to holding the rendition of the complex tax avoidance advice by the financial planner defendants was not subject to New Jersey's Consumer Fraud Act,<sup>1145</sup> *Finderne* addressed two important aspects of damages recoverable in such situations: (1) the basic theory underlying recoverable damages; and (2) whether income tax benefits recognized by a plaintiff reduce recoverable damages.<sup>1146</sup>

With regard to the basic theory of damages, in connection with the trial below, a motion judge decided the plaintiffs could only collect out-of-pocket damages and not expectancy, benefit-of-the-bargain, damages.<sup>1147</sup> The judge held that benefit-of-the-bargain damages were not appropriate because they would result in an inappropriate windfall to the plaintiffs.<sup>1148</sup> In effect, such damages would result in the plaintiffs receiving the tax benefits promised by the promoters of the EPIC plan even though those benefits were clearly not available under the I.R.C.<sup>1149</sup> On appeal, the court agreed with this reasoning.<sup>1150</sup> *Finderne* acknowledged that the appropriate measure of damages in fraud cases was a "perplexing problem."<sup>1151</sup> While New Jersey does recognize benefit-of-the-bargain damages in fraud situations, the court ultimately agreed with the motion judge that the effect of awarding such damages would be to enforce the EPIC contract and give the plaintiffs unwarranted tax benefits.<sup>1152</sup> The court seemed to view the promised EPIC benefits as an illegal contract, which the court refused to enforce.<sup>1153</sup> To buttress its conclusion, *Finderne* also noted that to obtain a benefits-of-the-bargain recovery would require the damages claimed to be established with "sufficient certainty."<sup>1154</sup> Here, the court held, the plaintiffs' damages did not meet this threshold because: "[t]he projected retirement benefits analysis given to plaintiffs were estimates, contingent on issues including the amount of the conversion credits as allowed by the

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<sup>1144</sup> *Id.* at 947–48.

<sup>1145</sup> *Id.* at 956.

<sup>1146</sup> *Id.*

<sup>1147</sup> *Id.*

<sup>1148</sup> *Id.*

<sup>1149</sup> *Id.*

<sup>1150</sup> *Id.* at 957.

<sup>1151</sup> *Id.*

<sup>1152</sup> *Id.*

<sup>1153</sup> *See id.* at 958.

<sup>1154</sup> *Id.* at 957.



insurance company, . . . [plaintiffs'] experience rating, or possible future changes in the tax laws."<sup>1155</sup> Interestingly, the court also noted the plaintiffs' dirty hands in that they knew their EPIC participation involved taking advantage of a very narrow tax exclusion and that they were significantly overpaying for the insurance and claiming a tax deduction for the inflated amount.<sup>1156</sup> One may wonder whether this influenced the court's holding.

Concerning whether any income tax benefits obtained by the plaintiff as a result of the losses caused by the defendants may reduce the recoverable damages, the trial judge below dealt with this issue in a very Solomonic fashion. At trial the plaintiffs argued for a jury instruction telling the jury to ignore any tax savings.<sup>1157</sup> The defendants maintained that any damages should be reduced by the tax deductions taken by the plaintiffs for the four years the IRS did not challenge.<sup>1158</sup> Not wishing to resolve this issue, the trial judge included both positions in his charge to the jury and left this issue entirely to the jury.<sup>1159</sup>

With such a wise disposition, on appeal *Finderne* affirmed the trial judge, finding no legal error present.<sup>1160</sup> In analyzing the issue, *Finderne* did hold that *Randall v. Loftsgaarden*, in which the United States Supreme Court held a tax benefit flowing from an investment did not reduce damages recoverable under federal securities laws based on fraud in a prospectus, did not apply to situations such as the present one.<sup>1161</sup> The court also noted that in *Burdett v. Miller*, the Seventh Circuit held that tax benefits received must be considered in determining damages.<sup>1162</sup> Finally, *Finderne* strongly suggested that New Jersey's strong public policy against permitting double recoveries might apply and thereby require the reduction of damages for tax benefits received.<sup>1163</sup>

Unlike *Vig* and *Finderne*, which involved bad I.R.C. § 419 welfare benefit plans, *Kelter v. Hartstein* involved a bad pension plan under IRC

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<sup>1155</sup> *Id.* at 957.

<sup>1156</sup> *Id.*

<sup>1157</sup> *Id.* at 959.

<sup>1158</sup> *Id.*

<sup>1159</sup> *Id.*

<sup>1160</sup> *Id.* at 961.

<sup>1161</sup> *Id.* at 960 (citing *Randall v. Loftsgaarden*, 478 U.S. 647, 659–60 (8th Cir. 1986)).

<sup>1162</sup> *Id.* (citing *Burdett v. Miller*, 957 F.2d 1375, 1383 (7th Cir. 1992)).

<sup>1163</sup> *Id.* at 960–61.

section 412(i).<sup>1164</sup> Although *Vig* and *Finderne* each used the term tax shelter to describe the arrangements involved in those cases, in *Kelter* the tax shelter aspect seems more pronounced. It reminds one of the abusive generic shelters, and perhaps, may belong in the same category.<sup>1165</sup>

Under I.R.C. section 412(i) plans, an employer holds in a trust an insurance policy on the life of each plan participant.<sup>1166</sup> Each year the employer funds the trust to pay the insurance premiums and receives a tax deduction for the amount paid.<sup>1167</sup> When a plan participant retires, the insurance policy on the participant's life is sold and the proceeds used to purchase an annuity to pay the participant her or his retirement benefits.<sup>1168</sup> Because all the premiums paid under the plan are deductible, taxpayers have attempted to shelter large amounts of income in such plans.<sup>1169</sup> The IRS responded by identifying certain plans as abusive tax shelters not entitled to any tax benefits.<sup>1170</sup> The abusive plans are ones funded solely with life insurance policies that (a) provide death benefits above the level permitted by section 412(i); (b) pay extremely high compensation to the salespeople; and (c) carry exorbitant surrender charges that essentially prevent an employer from terminating the insurance early.<sup>1171</sup>

An insurance company, the defendant ECI GROUP, a pension planner, and defendant attorney Bryan Cave developed the Pendulum Plan involved in *Kelter*, which contained each of these characteristics, in the late 1990s.<sup>1172</sup> In 1999, defendant ECI was warned about the possibility its plan was abusive.<sup>1173</sup> In June, 2003, ECI announced it would stop marketing the plan in December, 2003.<sup>1174</sup> Nevertheless, ECI sold this plan to plaintiffs in December, 2003.<sup>1175</sup> The plaintiffs were reassured by those involved with

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<sup>1164</sup>No. G042753, 2011 WL 2556033, at \*1–2 (Cal. Ct. App. June 28, 2011); I.R.C. § 412(i) (2006).

<sup>1165</sup>Part II *supra*.

<sup>1166</sup>I.R.C. § 412(i) (2006).

<sup>1167</sup>*Id.*

<sup>1168</sup>*Id.*

<sup>1169</sup>*Kelter*, 2011 WL 2556033, at \*1.

<sup>1170</sup>*Id.*

<sup>1171</sup>*Id.*

<sup>1172</sup>*Id.* at \*2.

<sup>1173</sup>*Id.*

<sup>1174</sup>*Id.*

<sup>1175</sup>*Id.*

selling the plan that the plan was valid for income tax purposes.<sup>1176</sup> They were never warned about the tax risks associated with the plan.<sup>1177</sup>

In February, 2004, the IRS issued two revenue rulings and proposed regulations further defining abusive section 412(i) plans.<sup>1178</sup> Although ECI informed plaintiffs of the proposed regulations, both ECI and Bryan Cave assured the plaintiffs the plan was valid and urged them to continue paying the insurance premiums.<sup>1179</sup> In April, 2004, plaintiffs retained defendant attorney Bryan Cave to obtain an IRS determination letter that plaintiffs' plan seemed valid.<sup>1180</sup> The favorable letter was obtained in March, 2005.<sup>1181</sup> In early 2006, the IRS notified the plaintiffs that the plan would be audited to determine whether it was qualified.<sup>1182</sup> The audit resulted in a final determination by the IRS in June, 2007, that the plan was abusive and not qualified under section 412(i).<sup>1183</sup> Bryan Cave represented plaintiffs on this audit.<sup>1184</sup> This suit was commenced in September, 2008.<sup>1185</sup> At that time the plaintiffs and the IRS were still negotiating how much back taxes, interest and penalties plaintiffs would be required to pay.<sup>1186</sup>

This suit was brought against the insurance companies, pension planners, financial advisors, accountants, attorneys, and other professionals who developed and sold plaintiffs the plan.<sup>1187</sup> The damages sought were to recover all contributions to the plan, all back taxes, interest and penalties to be assessed by the IRS, and the cost incurred during the IRS audit.<sup>1188</sup>

Unfortunately, *Kelter* does not address the substance of the asserted claims. The trial court dismissed the complaint against ECI and Bryan Cave on statute of limitations grounds and, alternatively, also dismissed one cause of action (breach of fiduciary duty) against ECI and all causes of action against attorney Bryan Cave on other grounds.<sup>1189</sup> On appeal, the

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<sup>1176</sup> *Id.*

<sup>1177</sup> *Id.*

<sup>1178</sup> *Id.*

<sup>1179</sup> *Id.*

<sup>1180</sup> *Id.*

<sup>1181</sup> *Id.*

<sup>1182</sup> *Id.* at \*3.

<sup>1183</sup> *Id.*

<sup>1184</sup> *Id.*

<sup>1185</sup> *Id.*

<sup>1186</sup> *Id.*

<sup>1187</sup> *Id.*

<sup>1188</sup> *Id.* at \*1.

<sup>1189</sup> *Id.*

court reversed the dismissal on statute of limitations grounds.<sup>1190</sup> The lower court held the statute of limitations began to run in December, 2003, when plaintiffs adopted the plan and paid the first premium.<sup>1191</sup> However, the appellate court held the statute of limitations did not begin to run until June, 2007, when the IRS issued its final determination that the plan was abusive and disallowed plaintiffs' tax deductions.<sup>1192</sup> The court did affirm the lower court's alternative holding, dismissing one count against defendant ECI because the plaintiffs never established the existence of any fiduciary relationship between them and ECI,<sup>1193</sup> and all counts against defendant Bryan Cave because of various pleading defects.<sup>1194</sup>

*Denenberg v. Rosen* also involved a Pendulum Plan and certain of the same defendants as in *Kelter*,<sup>1195</sup> such as Hartstein, ECI, and, for the tax malpractice focus, the law firm of Bryan Cave.<sup>1196</sup> The crux of the complaint was that the defendants induced the plaintiff to establish a pension plan funded with life insurance policies that guaranteed tax benefits that were later disallowed by the IRS, resulting in the loss of deductions and the imposition of excise taxes.<sup>1197</sup> The plaintiff adopted the plan in December, 2002, but it was effective as of October 1, 2001.<sup>1198</sup>

The claim of malpractice against Bryan Cave and the individual attorney who did the work was based primarily on the fact that the marketing materials contained a September, 1999, opinion from Bryan Cave that the plan was legal.<sup>1199</sup> The opinion, however, contained a caveat that it was issued only to the promoter and advised that each employer considering participation in the plan should obtain their own advice relating to tax matters.<sup>1200</sup> The plaintiff also signed an acknowledgment in connection with his adoption of the plan, that it was his responsibility to obtain legal and tax advice concerning the plan and that he disclaimed relying on any tax information provided by the promoters.<sup>1201</sup> The plaintiff also retained Bryan

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<sup>1190</sup> *Id.*

<sup>1191</sup> *Id.*

<sup>1192</sup> *Id.* at \*4.

<sup>1193</sup> *Id.* at \*1.

<sup>1194</sup> *Id.*

<sup>1195</sup> *Id.*

<sup>1196</sup> 897 N.Y.S.2d 391, 392–93 (App. Div. 2010).

<sup>1197</sup> *Id.* at 392.

<sup>1198</sup> *Id.* at 394.

<sup>1199</sup> *Id.* at 393.

<sup>1200</sup> *Id.*

<sup>1201</sup> *Id.* at 394.

Cave to submit the form of the plan for IRS approval, which was obtained in April, 2002,<sup>1202</sup> and for representation at the IRS audit of the plan in 2004–2005.<sup>1203</sup>

The First Department reversed the lower court's order denying Bryan Cave's motion to dismiss, because there was no attorney-client relationship between the plaintiff and Bryan Cave in 2002 when the plan was adopted.<sup>1204</sup> Also, there was no proof of any malpractice by Bryan Cave.<sup>1205</sup> The form of the Pendulum Plan was valid.<sup>1206</sup> It was the plaintiff's operation of the plan that was not acceptable, since the plan used life insurance as a tax shelter "in amounts that greatly exceeded both IRS imposed limits and the terms of the plan document prepared by Bryan Cave and approved by the IRS."<sup>1207</sup> The other work performed by Bryan Cave—submitting the plan form for IRS approval and representation before the IRS—was performed competently.<sup>1208</sup>

*Bhatia v. Dischino* is similar to *Kelter*. In *Bhatia*, the plaintiffs were a married couple who were advised by their accountant in October, 2004, to establish a § 412(i) retirement plan for the wife's private psychology practice.<sup>1209</sup> After consulting with their accountant's boss (defendant Dischino), a financial advisor, an executive benefit planning company (defendant ECI), a company that administers and manages retirement plans, and an insurance company (defendant Indianapolis Life), they decided to proceed and established their plan on March 30, 2005.<sup>1210</sup> According to the complaint, none of the advisors or defendants ever mentioned the possibility that the § 412(i) plan might be considered an abusive tax shelter or that certain forms were required by the IRS to be filed for such plans, despite the fact the IRS had issued two rulings addressing such plans in February, 2004, and had apparently been cautioning against the potential illegal use of such plans since 1989.<sup>1211</sup> The plaintiffs' plan received a

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<sup>1202</sup> *Id.*

<sup>1203</sup> *Id.* at 397.

<sup>1204</sup> *Id.* at 396.

<sup>1205</sup> *See id.* at 397.

<sup>1206</sup> *See id.* at 396.

<sup>1207</sup> *Id.*

<sup>1208</sup> *See id.* at 397.

<sup>1209</sup> No. 3:09-CV-1086-B, 2011 WL 3820825, at \*1 (N.D. Tex. Aug. 29, 2011).

<sup>1210</sup> *Id.* at \*1–2.

<sup>1211</sup> *Id.* The plaintiffs apparently received a disclosure form from the insurance company when they purchased their policy disclosing the IRS guidance and the risks with using a life insurance policy to fund a section 412(i) plan. *Id.* at \*2 n.3.

favorable IRS determination in October, 2005.<sup>1212</sup> However in June, 2006, a Notice of Summons was served upon ECI regarding the plan and the IRS subsequently audited the plan.<sup>1213</sup>

As a result of the IRS audit, the following problems with the plan were uncovered: first, the plan was operating as an abusive and impermissible tax shelter, allegedly caused by misfeasance of the actuary;<sup>1214</sup> second, the accountant had failed to file the required tax shelter Disclosure Form 8886 for the prior two years;<sup>1215</sup> finally, the accountant had regularly misfiled forms and had been forced to re-file, incurring penalties for the plaintiffs without their knowledge.<sup>1216</sup> Upon receiving the audit letter from the IRS, the plaintiffs dissolved the plan.<sup>1217</sup>

The damages suffered by the plaintiffs included over \$50,000 in under-reporting penalties and \$900,000 in penalties for failing to file Form 8886, as well as other back taxes and interest.<sup>1218</sup> When the plaintiffs cashed out their plan's insurance policy they lost almost \$267,000, the difference between their contributions to the plan (\$496,500) and the cash value (\$229,500).<sup>1219</sup> Finally, in order to cash out the original insurance policy, the plaintiffs were forced to accept another policy in exchange.<sup>1220</sup> The terms of the new policy allegedly were misrepresented to the plaintiffs, ultimately causing an additional \$270,000 in further losses.<sup>1221</sup>

As in *Kelter*, the court in *Bhatia* also never reached the substantive issues. In *Bhatia*, defendants Indianapolis Life and ECI each moved for judgment on the pleadings.<sup>1222</sup> The court granted Indianapolis Life's motion since the plaintiffs' pleadings were deficient in setting forth the asserted causes of action.<sup>1223</sup> With respect to ECI, the court granted the defendant's motion with respect to plaintiffs' fraud, ERISA and rescission claims.<sup>1224</sup> However, the court denied the motion with respect to the plaintiffs' claim

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<sup>1212</sup>*Id.* at \*2.

<sup>1213</sup>*Id.*

<sup>1214</sup>*Id.*

<sup>1215</sup>*Id.*

<sup>1216</sup>*Id.*

<sup>1217</sup>*Id.*

<sup>1218</sup>*Id.*

<sup>1219</sup>*Id.* at \*3.

<sup>1220</sup>*See id.*

<sup>1221</sup>*Id.*

<sup>1222</sup>*Id.* at \*5.

<sup>1223</sup>*Id.* at \*11.

<sup>1224</sup>*Id.* at \*12, \*15-16.

for breach of fiduciary duty, professional negligence/malpractice and negligence.<sup>1225</sup>

*MCNC v. Aon Consulting, Inc.* did not involve any tax shelters, but simply incorrect tax advice given by defendant, a benefit consulting firm.<sup>1226</sup> The plaintiff was a tax exempt nonprofit organization.<sup>1227</sup> It had maintained a pension plan for its employees since 1983.<sup>1228</sup> In 1995, it sought to enhance its plan and retained the defendant for advice.<sup>1229</sup> Based on defendant's advice, the plaintiff amended its plan as of April 1, 1996, to provide for mandatory contributions from its employees, which, based on defendant's advice, would not be subject to federal income or social security taxes.<sup>1230</sup>

In addition to the advice in 1995–96 concerning the plan amendment, the defendant provided various plan related services until January, 2002.<sup>1231</sup> These services included preparing the plan's annual report (IRS Form 5500) filed with the Department of Labor, and summary annual reports given to plan participants, as well as other services.<sup>1232</sup> In 2002, the plaintiff terminated its relationship with the defendant and retained outside counsel to prepare its annual reports.<sup>1233</sup>

In 2003, the plaintiff was informed by its outside counsel that the defendant's advice concerning the mandatory contributions was wrong and that taxes might be owed on past contributions.<sup>1234</sup> In addition to changing its plan to eliminate the mandatory contributions, it voluntarily notified the IRS and Social Security Administration of its error.<sup>1235</sup> The plaintiff worked out a settlement with the IRS that required no payment of back taxes.<sup>1236</sup> It did pay social security taxes for 2002–2004, the open tax years.<sup>1237</sup> Neither agency ever issued a formal assessment against the plaintiff.<sup>1238</sup> Plaintiff

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<sup>1225</sup> *Id.* at \*15, \*17–18.

<sup>1226</sup> No. 1:05CV00194, 2006 WL 3733267, at \*2 (M.D.N.C. Dec. 14, 2006).

<sup>1227</sup> *Id.* at \*1.

<sup>1228</sup> *Id.*

<sup>1229</sup> *Id.*

<sup>1230</sup> *Id.*

<sup>1231</sup> *Id.*

<sup>1232</sup> *Id.* at \*1–2.

<sup>1233</sup> *Id.* at \*2.

<sup>1234</sup> *Id.*

<sup>1235</sup> *Id.*

<sup>1236</sup> *Id.*

<sup>1237</sup> *Id.*

<sup>1238</sup> *Id.*

also incurred attorneys' fees and a \$5,000 fee to IRS in connection with these settlements.<sup>1239</sup> It then instituted this action against the defendant for negligent misrepresentation and professional malpractice.<sup>1240</sup> This case resulted in a denial of the defendant's motion for summary judgment.<sup>1241</sup>

As an initial matter, the court in *MCNC* decided that the defendant was acting as a "professional" in giving tax advice to the plaintiff and treated this as a professional malpractice claim under North Carolina law.<sup>1242</sup> The main focus of the case was on the statute of limitations. The defendant argued both that the statute of limitations never commenced running and that the claim was barred by the statute of limitations.<sup>1243</sup>

The more interesting issue concerned the defendant's argument that the statute of limitations never commenced because the plaintiff voluntarily worked out settlements with the IRS and the Social Security Administration and neither ever issued an assessment against the plaintiff. This argument was based on a North Carolina case that held the statute of limitations against an attorney and accountant for wrong tax advice commenced to run when the IRS assessed additional tax.<sup>1244</sup> Limiting *Snipes* to its facts, the *MCNC* court held that as a matter of public policy, taxpayers need to be encouraged to voluntarily come forth and settle tax mistakes.<sup>1245</sup> To lose one's malpractice claim because one voluntarily reports and settles tax problems prior to an IRS assessment makes no sense. According to the court, any contrary holding would force taxpayers to choose between (1) losing their malpractice claim by voluntarily addressing it prior to an IRS assessment, or (2) keeping silent and hoping the error is never discovered, but if it is, to salvage their malpractice claim.<sup>1246</sup> The court also indicated other public policy reasons to hold that a plaintiff's claim accrues when it voluntarily notifies the IRS.<sup>1247</sup> First, by voluntarily notifying the IRS, plaintiff may avoid greater damages, thus mitigating damages for itself

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<sup>1239</sup> *Id.*

<sup>1240</sup> *Id.*

<sup>1241</sup> *Id.* at \*1. The court adopted the Recommendation and Order of the Magistrate Judge to whom the case was referred. *Id.*

<sup>1242</sup> *Id.* at \*3.

<sup>1243</sup> *Id.* at \*1.

<sup>1244</sup> *Id.* at \*4. The North Carolina case is *Snipes v. Jackson*, 316 S.E.2d 657, 659 (N.C. Ct. App. 1984).

<sup>1245</sup> *MCNC*, 2006 WL 3733267, at \*4.

<sup>1246</sup> *Id.*

<sup>1247</sup> *Id.* at \*4, n.2.



and the defendant.<sup>1248</sup> And second, as a fiduciary, plaintiff had a duty to the plan and its participants to protect them from the consequences of any mistakes that had been made.<sup>1249</sup>

As to the defendant's argument that the statute of limitations had already expired on the theory that it commenced to run in 1995 or 1996, when the plan was amended to include the mandatory contributions, the court held the statute commenced running in 2002 when the defendant prepared its last plan report.<sup>1250</sup> Until then, the statute was suspended due to the ongoing relationship between the parties and the defendant's obligation to prepare an accurate annual report.<sup>1251</sup>

*Fownes Bros. & Co. v. JP Morgan Chase & Co.* also involved incorrect tax advice concerning a benefit plan.<sup>1252</sup> In March 2000, with the assistance of the defendants, the plaintiff established an employee death benefit plan that was to be funded with life insurance policies.<sup>1253</sup> In May 2003, the managers of the plan notified the plaintiff that the plan did not comply with IRS regulations and that the plaintiff would need to terminate participation in the plan by the end of 2003.<sup>1254</sup> The plaintiff consulted with the defendants concerning its options.<sup>1255</sup> In October 2003, the plaintiff was advised by defendant Chase's vice president of its insurance brokerage and advisory services to terminate its participation in the plan and to transfer the insurance policies to a welfare benefit trust.<sup>1256</sup> The plaintiff was advised the transfer should be nontaxable and that further premiums would be deductible.<sup>1257</sup> After the plaintiff's accountant, defendant Grant Thornton, concurred with Chase's advice, the plaintiff followed the advice.<sup>1258</sup> On its tax return for 2003, the amount of the policies transferred to the new plan was not included in gross income.<sup>1259</sup> In March 2007, the IRS notified the plaintiff that terminating their participation in the original plan was a

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<sup>1248</sup> *Id.*

<sup>1249</sup> *Id.*

<sup>1250</sup> *Id.* at \*7.

<sup>1251</sup> *Id.*

<sup>1252</sup> No. 603012/09, 2010 WL 5782547, at \*2 (N.Y. Sup. Ct. Nov. 26, 2010), *aff'd*, 939 N.Y.S.2d 367 (App. Div. 2012). The benefit plan was under I.R.C. § 419A(f)(6) (2012).

<sup>1253</sup> *Fownes*, 2010 WL 5782547, at \*2.

<sup>1254</sup> *Id.*

<sup>1255</sup> *Id.*

<sup>1256</sup> *Id.*

<sup>1257</sup> *Id.*

<sup>1258</sup> *Id.*

<sup>1259</sup> *Id.*

taxable event, for which they incurred back-taxes and penalties of over \$900,000.<sup>1260</sup> This suit was commenced in September 2009 by the plaintiff to recover its damages.<sup>1261</sup>

The court dismissed all but one of the plaintiff's causes of action on statute of limitations grounds<sup>1262</sup> and because there were no allegations the defendants knowingly made false statements.<sup>1263</sup> The only claim that survived was a claim for unjust enrichment against the accountant defendant, since there was a possibility the plaintiff might be able to recover the fees paid the accountant.<sup>1264</sup> The plaintiff was given leave to replead this cause of action with greater specificity.<sup>1265</sup>

Although the plaintiff's fraud cause of action was dismissed essentially because there was no allegation that either defendant knowingly made false statements, it is noteworthy that the trial court and the First Department also proceeded to indicate that under New York's out-of-pocket measure of damages for fraud, taxes paid are not recoverable and the plaintiff therefore failed to allege recoverable damages.<sup>1266</sup>

Plaintiffs' tax liability did not flow naturally from the alleged misrepresentations by defendants, but rather from the taxable event created when plaintiffs switched from one employee benefit plan to another . . . The fact that plaintiffs may have performed the transfer pursuant to advice from defendants does not convert plaintiffs' tax liability into consequential damages . . . .<sup>1267</sup>

It seems almost incomprehensible that if a professional were to give fraudulent advice to another who follows the advice and thereby incurs

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<sup>1260</sup> *Id.*

<sup>1261</sup> *Id.* The amount of damages sought is not clear. After presenting the basic facts the opinion states the plaintiff sought to recover as damages "the additional taxes assessed against them by the IRS." *Id.* It is unclear whether all taxes paid or only some lesser amount was sought. Similarly, the court never separates the penalties from the taxes. From a jurisprudential perspective these issues are significant. The court probably never focused on these issues since it dismissed virtually all causes of action. *Id.* at \*7.

<sup>1262</sup> *Id.* at \*4.

<sup>1263</sup> *Id.* at \*5.

<sup>1264</sup> *Id.* at \*7.

<sup>1265</sup> *Id.*

<sup>1266</sup> *Fownes Bros. & Co. v. JP Morgan Chase & Co.*, 939 N.Y.S.2d 367, 368 (App. Div. 2012); *Fownes*, 2010 WL 5782547, at \*5-6.

<sup>1267</sup> *Fownes*, 939 N.Y.S.2d at 368.

additional taxes, no remedy would be available under New York fraud law. In addition, it seems to me, that regardless of the logic of the basic rule, any penalties incurred are recoverable damages.<sup>1268</sup>

Although pertaining to a pension plan, a rather complex area of tax law, *In-Line Suspension, Inc. v. Weinberg & Weinberg, P.C.* illustrates the need to adhere to basics to document important decisions. In *In-Line*, the plaintiff was a corporation that had a pension and profit sharing plan and the defendant was the attorney who did work for the plan.<sup>1269</sup> The plaintiff had both salaried and commissioned employees.<sup>1270</sup> The plan was to cover only the salaried employees.<sup>1271</sup> In 1997, the plan was amended, and under the amendment the plan was extended to all employees.<sup>1272</sup> The plaintiff and defendant disagreed as to whether this change was authorized by the plaintiff.<sup>1273</sup> In early 2000, the plaintiff first learned of the extension of the plan to the commissioned employees.<sup>1274</sup> In addition to revising the plan, the plaintiff then needed to make contributions for 1997 and 1998 for the commissioned employees, pay interest on the late contributions and pay IRS imposed fees.<sup>1275</sup> The plaintiff also elected not to make contributions for any employees for 1999 in order to avoid making contributions for the commissioned employees for that year.<sup>1276</sup>

The plaintiff then instituted this malpractice action to recover the additional contributions paid for the commissioned employees, the additional interest, fees and costs, and also for over \$10,000 for the “loss of value” to the plaintiff and the owner for the omitted 1999 contributions.<sup>1277</sup> Presumably, this latter item was the additional income taxes the plaintiff incurred for 1999 because there was no pension contribution made for that year.<sup>1278</sup>

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<sup>1268</sup> See *Tax Malpractice Damages*, *supra* note 38, at 731.

<sup>1269</sup> 687 N.W.2d 418, 421 (Neb. Ct. App. 2004).

<sup>1270</sup> *Id.*

<sup>1271</sup> *Id.*

<sup>1272</sup> *Id.* at 422.

<sup>1273</sup> *Id.* at 422–23.

<sup>1274</sup> *Id.* at 422.

<sup>1275</sup> *Id.*

<sup>1276</sup> *Id.*

<sup>1277</sup> *Id.* at 422–23.

<sup>1278</sup> A jury instruction was requested for the jury to be instructed to include the extra taxes as an element of damages. See *id.* at 426.

At trial, the plaintiffs received a jury verdict of over \$46,000.<sup>1279</sup> The appellate court reversed and remanded for a new trial because testimony by the defendant's expert was erroneously excluded at the trial.<sup>1280</sup>

Although not addressed by the court due to the remand, one of the errors asserted by the defendant was that the damages awarded by the jury did not reflect tax consequences and were therefore excessive.<sup>1281</sup> Alas, another opportunity to visit this issue was lost.

## 2. S-Corporations

An S-corporation is a special type of corporation that generally is not subject to the income tax imposed on corporations.<sup>1282</sup> Instead, it is treated as a conduit.<sup>1283</sup> It files a tax return and reports its financial results,<sup>1284</sup> but its income and deductions flow through and are taxed to the shareholders on their tax returns.<sup>1285</sup> To qualify for S-corporation treatment, a corporation must meet certain conditions and must elect such treatment.<sup>1286</sup> All four recent cases involving S-corporations focus on procedural issues and not on the merits of the asserted claims.

In *Boerger v. Heiman*, the plaintiff had owned two apartment complexes since the 1980s.<sup>1287</sup> In 1997, the plaintiff needed to refinance the mortgages on the complexes and instructed his attorney to work out the details.<sup>1288</sup> The complexes were transferred to a limited liability company, and eventually the plaintiff, Boerger, became the sole owner of two corporations, which owned, respectively, 99 percent and 1 percent of the limited liability company.<sup>1289</sup> Boerger was aware that if he owned property through a corporation double taxation would result.<sup>1290</sup> When he asked his attorney whether this restructuring had any adverse tax consequences, the attorney

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<sup>1279</sup> *Id.*

<sup>1280</sup> *Id.* at 429.

<sup>1281</sup> *Id.* at 426–27.

<sup>1282</sup> I.R.C. § 1363(a) (2012); *See generally* BITTKER & EUSTICE, *supra* note 252 at 6-6, -25.

<sup>1283</sup> BITTKER & EUSTICE, *supra* note 252 at 6-26 to -27.

<sup>1284</sup> *See* I.R.C. § 1363(b) (2012).

<sup>1285</sup> I.R.C. § 1366(a)-(b) (2012).

<sup>1286</sup> *See* I.R.C. § 1361(a)(1) (2012).

<sup>1287</sup> 965 A.2d 671, 673 (Del. 2009).

<sup>1288</sup> *Id.*

<sup>1289</sup> *Id.*

<sup>1290</sup> *Id.*

assured him there would be no adverse tax consequences.<sup>1291</sup> The court indicated the attorney's reassurance might have been accurate if S-corporation status had been timely elected for the two corporations.<sup>1292</sup> However, neither Boerger's attorney nor his accountant at that time made the election.<sup>1293</sup>

In 1999, Boerger hired a new accountant to prepare his and his corporations' tax returns.<sup>1294</sup> The accountant told Boerger that because the corporations were not S-corporations he would be subject to double tax if the corporations were ever profitable, but since the corporations had losses, Boerger could wait until the corporations became profitable before electing S-corporation status.<sup>1295</sup> In 2004, Boerger received an offer to buy one of the apartment complexes.<sup>1296</sup> When inquiring about the tax implications of selling, he was advised by his accountant that there would be double taxation because the corporations were not S-corporations.<sup>1297</sup> As a consequence, Boerger did not sell the complex.<sup>1298</sup> He then instituted this action against his attorney, his former accountant, and his present accountant, each for not electing S-corporation status either initially or in 1999.<sup>1299</sup> The trial court granted the defendants' motion for summary judgment on statute of limitations grounds.<sup>1300</sup> In *Boerger*, the Delaware Supreme Court reversed and remanded the action for trial.<sup>1301</sup>

Under certain circumstances, an S-corporation that previously was a regular C Corporation will incur tax when its passive investment income exceeds twenty-five percent of its gross receipts.<sup>1302</sup> If this situation persists for three consecutive taxable years, the corporation's S election is terminated.<sup>1303</sup> In *Federated Industries, Inc. v. Reisin*, the plaintiffs were an

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<sup>1291</sup> *Id.*

<sup>1292</sup> *Id.*

<sup>1293</sup> *Id.*

<sup>1294</sup> *Id.*

<sup>1295</sup> *Id.* at 673–74. There was conflicting testimony whether the accountant explained the current tax ramifications to Boerger or whether she simply told him that he could elect S-corporation status in the future when the corporations became profitable. *Id.* at 675.

<sup>1296</sup> *Id.* at 674.

<sup>1297</sup> *Id.*

<sup>1298</sup> *Id.*

<sup>1299</sup> *Id.*

<sup>1300</sup> *Id.* at 673.

<sup>1301</sup> *Id.* at 676.

<sup>1302</sup> I.R.C. § 1375(a) (2012).

<sup>1303</sup> I.R.C. § 1362(d)(3) (2012).

S-corporation and its owners who found themselves in this situation.<sup>1304</sup> The defendants were the S-corporation's accountant and his firm who were hired to prepare the corporation's tax returns and to advise when passive income was likely to exceed the twenty-five percent threshold.<sup>1305</sup> If advised properly, the corporation could have shifted its investments to yield non-passive income.<sup>1306</sup> The defendants under-calculated the plaintiff's passive investment income for 2002, 2003 and 2004.<sup>1307</sup> As a result, the plaintiffs incurred additional taxes and penalties and its S-corporation status was jeopardized.<sup>1308</sup> This suit was then commenced. The court affirmed the trial court's dismissal of the case on statute of limitations grounds,<sup>1309</sup> and never addressed any substantive issues.

In *Berg v. Hirschy*, the plaintiffs were the shareholders of an S-corporation who had converted their S-corporation to a limited liability company on the advice of the defendant attorney.<sup>1310</sup> The plaintiffs alleged the defendant negligently failed to advise them that there could be additional adverse tax consequences if a tax authority were to ascribe some goodwill or going concern value to the corporation.<sup>1311</sup> The tax returns were filed without reference to any such value, and no tax authority had yet asserted any claim for additional taxes when this suit was commenced.<sup>1312</sup> This suit was commenced seeking a declaratory judgment that the defendant would be liable for any taxes that might be incurred in the future, or, alternatively, that for statute of limitations purposes, no malpractice claim had yet occurred.<sup>1313</sup> *Berg* affirmed the trial court's dismissal of the action at the pleading stage because there was no justiciable controversy.<sup>1314</sup> In the absence of any claim for additional taxes from any taxing authority, the

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<sup>1304</sup> 927 N.E.2d 1253, 1255 (Ill. App. Ct. 2010).

<sup>1305</sup> *Id.*

<sup>1306</sup> *Id.*

<sup>1307</sup> *Id.* at 1255. There was also a finding by the IRS that plaintiff also had excessive passive investment income in 2000 and 2001. *Id.* at 1256.

<sup>1308</sup> *Id.* at 1254–55.

<sup>1309</sup> *Id.* at 1255.

<sup>1310</sup> 136 P.3d 1182, 1183 (Or. Ct. App. 2006).

<sup>1311</sup> *Id.* at 1184. It is interesting to note that the court refused to explain the nature of the alleged tax consequences. *Id.* at 1184 n.1.

<sup>1312</sup> *Id.* at 1184.

<sup>1313</sup> *Id.*

<sup>1314</sup> *Id.* at 1183.

court held the claim was entirely speculative since there might never be any claim.<sup>1315</sup>

In the tax malpractice area, a plaintiff often must traverse a very fine line. If suit is commenced too soon—before there are any cognizable damages—the suit is dismissed for being premature, since damages are normally an element of the cause of action. If a plaintiff waits until there definitely have been damages, the suit may be dismissed on statute of limitations grounds if the judge decides the cause of action accrued much earlier.<sup>1316</sup> In *Berg*, the plaintiffs attempted to resolve this dilemma by seeking alternative declaratory judgments. The Oregon Court of Appeals, however, refused to assist the plaintiffs because of considerations of justiciability. Plaintiffs' attorneys are thus left to their own devices to make a correct determination.

In *Berkowitz, Dick, Pollack & Bryant v. Smith*, the court affirmed the trial court's denial of the defendant accountant's motion to compel arbitration.<sup>1317</sup> The plaintiff owned an S-corporation and a *foreign corporation*.<sup>1318</sup> The accountant was retained to prepare the plaintiff's personal tax returns and to give the plaintiff tax advice.<sup>1319</sup> The alleged malpractice was defendant's failure to warn plaintiff of the adverse tax consequences that would result from an intercompany loan from the plaintiff's foreign corporation to his S-corporation.<sup>1320</sup> *Berkowitz* does not explain the underlying tax issue. However, it seems to be a general foreign tax issue not dependent on the S-corporation status of the borrower.<sup>1321</sup>

### 3. Tax Benefits and Elections

In *Skyline Duplication and Document Management, Corp. v. David Gronsbell & Co.*, a taxpayer sued its long-time accountants for failing to inform it that it qualified for federal Work Opportunity Tax Credits for hiring certain targeted classes of employees.<sup>1322</sup> While the defendants asserted a statute of limitations claim in this motion for summary judgment,

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<sup>1315</sup> *Id.* at 1184.

<sup>1316</sup> See *Malpractice II*, *supra* note 1 at 1067–70.

<sup>1317</sup> 49 So. 3d 309, 310 (Fla. Dist. Ct. App. 2011).

<sup>1318</sup> *Id.*

<sup>1319</sup> *Id.*

<sup>1320</sup> *Id.*

<sup>1321</sup> See I.R.C. § 951(a)(1) (2012).

<sup>1322</sup> See I.R.C. § 51(a)–(d) (2012); No. 604201/2005, 2010 WL 5621157, at \*1 (N.Y. Sup. Ct. Dec. 23, 2010).

the court sidestepped it.<sup>1323</sup> Instead, the court granted the defendants' summary judgment because the plaintiff failed to submit evidence that it had met all of the requirements needed to obtain the credit.<sup>1324</sup> Without evidence of damages, a cause of action was not stated.<sup>1325</sup> The plaintiff claimed it did not obtain or retain the required information because it was never informed by the defendant that it needed the information.<sup>1326</sup>

In reaching its decision, the court noted there was no clear evidence that the plaintiff either asked the defendant whether it qualified for the credit or directly inquired about this particular credit.<sup>1327</sup> This begs the question of whether the accountant had a duty to know of such tax provisions and to raise them with the client, especially where, as here, the accountant had a longstanding relationship with the client.<sup>1328</sup>

In *Bachand Estates LLP v. Hanft Fride, P.A.*, the plaintiffs purchased a senior retirement complex in Wisconsin in 2006.<sup>1329</sup> They desired to redevelop the property and qualify for federal tax credits for developing affordable multifamily rental housing.<sup>1330</sup> Relying in part on an opinion by the defendant attorney that the property qualified for four-percent credit on its acquisition cost, the plaintiffs decided to apply for a program under which four-percent credits were available for both the acquisition and rehabilitation costs.<sup>1331</sup> These credits were available to all applicants.<sup>1332</sup> Alternatively, a 9 percent credit could be obtained on only rehabilitation costs, but this program was competitive and not all applicants obtained the credit.<sup>1333</sup> On December 11, 2006, the plaintiffs learned that the defendant's opinion was incorrect and the property did not qualify for the four-percent credit on acquisition costs.<sup>1334</sup> The deadline for filing for the nine-percent

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<sup>1323</sup> *Skyline*, 2010 WL 5621157, at \*4.

<sup>1324</sup> *Id.* at \*5.

<sup>1325</sup> *Id.* at \*2.

<sup>1326</sup> *Id.* at \*4.

<sup>1327</sup> *Id.*

<sup>1328</sup> The defendant accountants prepared the plaintiff's tax returns from 1994 until 2004. *Id.* at \*2. The dispute apparently concerns employees hired from 1997 to 2006. *Id.*

<sup>1329</sup> No. 07-cv-334-JCS, 2008 WL 220285, at \*1 (W.D. Wis. Jan. 24, 2008).

<sup>1330</sup> *Id.*

<sup>1331</sup> *Id.*

<sup>1332</sup> *Id.*

<sup>1333</sup> *Id.*

<sup>1334</sup> *Id.*



credit was February 2, 2007.<sup>1335</sup> The plaintiff did not apply for the nine-percent credit.<sup>1336</sup> This action for damages ensued.<sup>1337</sup>

In this action the defendant moved for summary judgment arguing that the incorrect opinion did not cause any damages because the plaintiff's failure to seek the nine-percent credit was based on other business reasons.<sup>1338</sup> Since there were many disputed factual issues, the court denied the plaintiff's motion for summary judgment.<sup>1339</sup>

Under I.R.C. § 754, an election is available to a partnership to adjust the basis of its assets with respect to a partner that acquires an interest in a partnership by purchase or by inheritance.<sup>1340</sup> This election is very desirable when the present value of the partnership's assets exceeds its basis for tax purposes. In *Ames & Fischer Co., II v. McDonald*, events occurred in 2000 and 2001 that would have allowed the plaintiff partnerships to make favorable § 754 elections.<sup>1341</sup> However, the accountants who prepared the tax returns did not make the elections, and the attorneys who rendered business and estate planning advice to plaintiffs did not advise that the elections should be made.<sup>1342</sup> As a result, the plaintiffs lost a number of immediate and future tax benefits.<sup>1343</sup> This action against the accountants and attorneys ensued.<sup>1344</sup> This case, on a certified question from the trial court, only addressed the issue regarding when the statute of limitations commenced to run.<sup>1345</sup>

Mention should be made of *Nagle v. Cohen*, which simply contains a conclusory allegation that the defendant attorneys improperly advised the plaintiff not to elect "trader" status under the I.R.C.<sup>1346</sup> None of the facts

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<sup>1335</sup> *Id.* at \*1–2.

<sup>1336</sup> *Id.* at \*2.

<sup>1337</sup> *Id.*

<sup>1338</sup> *Id.*

<sup>1339</sup> *Id.* at \*3.

<sup>1340</sup> I.R.C. § 754 (2012).

<sup>1341</sup> 798 N.W.2d 557, 559 (Minn. Ct. App. 2011). The death of a partner in 2000 and the sale of partnership interests in 2001 would have qualified plaintiffs for section 754 elections. *Id.*

<sup>1342</sup> *Id.*

<sup>1343</sup> *Id.* at 559–60.

<sup>1344</sup> *Id.* at 560.

<sup>1345</sup> *Id.* at 564.

<sup>1346</sup> No.2009-098902-NM, 2010 WL 5129813, at \*1–2 (Mich. Ct. App. Dec. 16, 2010). There is also an equally cryptic and unexplained allegation that defendants provided incorrect tax advice. *Id.* at \*2. The reference to not electing trader status presumably applies to IRC § 475(f) pursuant

relevant to this claim are presented. The case affirms, on statute of limitations grounds, the trial court's grant of summary judgment to the defendant attorneys.<sup>1347</sup>

Similarly, in *Berg v. Eisner LLP*, there is a conclusory allegation the defendant accounting firm committed malpractice by failing to inform the plaintiff of a possible tax election that would have allowed the plaintiff to write off a portion of his securities trading losses.<sup>1348</sup> Presumably, this was the same election as was involved in *Nagle*.<sup>1349</sup> Here, the First Department reversed the trial court, which granted the defendant's motion to dismiss the complaint.<sup>1350</sup>

It should also be recalled that in *Goodman v. Hanson*, a case discussed previously, one of the asserted causes of action was that the defendant attorney deducted certain estate administration fees on a trust's income tax return rather than on the estate tax return, which was in a higher marginal tax bracket.<sup>1351</sup> The court did not address the substance of the complaint, but held that an earlier release signed by the parties prevented this claim from proceeding.<sup>1352</sup>

#### 4. Tax-Free Exchanges

Under I.R.C. § 1031, gain or loss is not recognized when certain property is exchanged for like-kind property.<sup>1353</sup> Instead, the tax consequences from the disposition of the initial property are deferred until the disposal of the replacement property.<sup>1354</sup> Where a direct exchange of properties is not possible, § 1031 is still available if a qualified intermediary

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to which a person in the trade or business of being a trader in securities may elect the mark-to-market method of accounting for this business. I.R.C. § 475(f) (2012).

<sup>1347</sup> *Nagle*, 2010 WL 5129813, at \*4–5.

<sup>1348</sup> 941 N.Y.S.2d 616, 617 (App. Div. 2012).

<sup>1349</sup> See *Nagle*, 2010 WL 5129813, at \*1–2.

<sup>1350</sup> *Berg*, 941 N.Y.S.2d at 617.

<sup>1351</sup> 945 N.E.2d 1255, 1255 (Ill. App. Ct. 2011); See *supra* text accompanying notes 617–631, and notes 745–748.

<sup>1352</sup> *Goodman*, 945 N.E.2d at 1270.

<sup>1353</sup> I.R.C. § 1031 (2012). To be eligible for section 1031 treatment both the initial and the replacement properties must be held for productive use in a trade or business or for investment. I.R.C. § 1031(a) (2012). Inventory, certain intangibles and interest in partnerships are not eligible for section 1031 treatment. *Id.*

<sup>1354</sup> *Wo Yee Hing Realty Corp. v. Stern*, No. 115517/07, 2011 WL 892757, at \*4 (N.Y. Sup. Ct. Feb. 10, 2011), *aff'd*, 99 A.D.3d 58 (N.Y. App. Div. 2012). This deferral is obtained by the basis provisions in I.R.C. section 1031(d).

is utilized to receive the sales proceeds from the sale of the initial property, the taxpayer never receives the sales proceeds (or any other non-like kind property), the taxpayer identifies the replacement property within 45 days of the disposition of the old property, and the taxpayer actually receives the replacement property within 180 days of the disposition of the old property.<sup>1355</sup>

As discussed previously, in *Wo Yee Hing Realty Corp. v. Stern*, a § 1031 exchange would have saved the taxpayer a substantial amount of immediate taxes—allegedly \$5.1 million.<sup>1356</sup> There was neither a written retainer agreement nor any other written evidence to establish who—the defendant attorney or the seller—had agreed to be responsible for complying with the § 1031 exchange requirements.<sup>1357</sup> Each party testified the other had undertaken this responsibility.<sup>1358</sup> While the parties focused on the fact that § 1031 treatment was unavailable because the plaintiff actually received the sales proceeds at the time of sale,<sup>1359</sup> the court granted summary judgment to the defendant attorney because the plaintiff failed to establish that all the other requirements for § 1031 treatment were met.<sup>1360</sup> Without such evidence, even if the defendant, *arguendo*, were negligent, there was still no proximate causation of any harm to the plaintiff since § 1031 would nevertheless have been unavailable.<sup>1361</sup>

In *Rashti v. Gadoshian*, the defendant CPA advised the plaintiffs, in connection with their sale of property in 2008, that substantial tax savings could be realized if they engaged in a § 1031 exchange.<sup>1362</sup> The defendant then recommended an intermediary to receive the proceeds of the sale and to facilitate the § 1031 exchange.<sup>1363</sup> Unfortunately, the intermediary stole most of the proceeds.<sup>1364</sup> Even after issues concerning the intermediary arose, the defendant allegedly continued to reassure the plaintiffs that their funds were safe, that the § 1031 requirements were being met, and not to take any legal action.<sup>1365</sup> This suit ensued, alleging professional negligence

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<sup>1355</sup> I.R.C. § 1031(a)(3) (2012); Treas. Reg. § 1.1031(k)-1(b) (2014).

<sup>1356</sup> *Wo Yee*, 2011 WL 892757, at \*3; *See supra* text accompanying notes 428–443.

<sup>1357</sup> *See Wo Yee*, 2011 WL 892757, at \*1–2.

<sup>1358</sup> *Id.*

<sup>1359</sup> *Id.* at \*2.

<sup>1360</sup> *Id.* at \*5.

<sup>1361</sup> *Id.*

<sup>1362</sup> No. B221198, 2010 WL 4679594, at \*1 (Cal. Ct. App. Nov. 19, 2010).

<sup>1363</sup> *Id.*

<sup>1364</sup> *See id.* at \*2.

<sup>1365</sup> *See id.* at \*1–2.

and breach of fiduciary duties.<sup>1366</sup> The lower court held there was no duty owed by the defendant to the plaintiffs and sustained the defendant's demurer, dismissing the complaint.<sup>1367</sup>

On appeal, the California intermediate appellate court reversed the lower court and held the defendant did owe a duty to the plaintiffs.<sup>1368</sup> The tax advice rendered by the defendant CPA concerning the § 1031 exchange clearly was within the scope of the defendant's professional services to the plaintiffs.<sup>1369</sup> Also, the court held the recommendation of an intermediary qualified to effectuate the § 1031 exchange was within the scope of the tax advice rendered.<sup>1370</sup>

It should be noted that the court explicitly distinguished this situation from a "simple referral."<sup>1371</sup> In this case, the referral was part and parcel of the tax advice.<sup>1372</sup> Also, while perhaps not directly relevant, it should be noted that there was an allegation that the defendant CPA was "a knowing participant in the criminal act" of the intermediary.<sup>1373</sup>

While the result in *Rashiti* seems correct, a line may need to be drawn between "simple referrals" and situations such as this one in which the referral is central to the professional services rendered. Exactly where the line should be drawn may not be easy to articulate.

Similar to *Rashiti*, in *Winters v. Dowdall*, the defendant attorney represented the plaintiff in connection with an exchange of properties under I.R.C. § 1031 in which a qualified intermediary was involved and this intermediary stole money deposited with it.<sup>1374</sup> The trial court denied the defendant's motion to dismiss and on this appeal the First Department unanimously affirmed.<sup>1375</sup> The plaintiff asserted that the defendant was retained to advise him in connection with the § 1031 transaction and with the selection of a qualified intermediary.<sup>1376</sup> The complaint also asserted the defendant failed to: (1) properly investigate the intermediary before selecting it; (2) ensure the intermediary was adequately bonded; (3) ensure

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<sup>1366</sup> *Id.* at \*2.

<sup>1367</sup> *Id.* at \*3.

<sup>1368</sup> *Id.*

<sup>1369</sup> *Id.* at \*3–4.

<sup>1370</sup> *Id.*

<sup>1371</sup> *Id.* at \*4.

<sup>1372</sup> *Id.*

<sup>1373</sup> *Id.* at \*5.

<sup>1374</sup> 882 N.Y.S.2d 100, 101 (App. Div. 2009).

<sup>1375</sup> *Id.*

<sup>1376</sup> *Id.*

the funds received by the intermediary were deposited into an account for the plaintiff's sole benefit; and (4) that these failures caused damages of over \$600,000.<sup>1377</sup> The First Department held the plaintiff's pleadings stated a valid malpractice cause of action.<sup>1378</sup>

In *Frank v. Lockwood*, the crux of the dispute between the parties was the allegedly incorrect advice given by the defendant accountant to the plaintiffs concerning the taxes to be incurred by the plaintiffs in connection with a § 1031 transaction.<sup>1379</sup> The opinion, however, focused solely on the recoverability of interest and penalties awarded by the jury to the plaintiffs as a result of the late payment of their taxes and the late filing of their tax returns for 2001.<sup>1380</sup> Especially noteworthy is the fact that the Nebraska Supreme Court held that interest incurred upon the late payment of taxes due to a tax advisor's negligence is recoverable in a tax malpractice action, though the burden of proving such damages is upon the plaintiff.<sup>1381</sup>

Before concluding this section, it should be noted that *Sanders v. Bressler, Amery & Ross, P.C.*, a case noted briefly at the end of this article, involved a failed § 1031 exchange.<sup>1382</sup>

## 5. Disposition/Acquisition of Property

In *Leggiadro, Ltd. v. Winston & Strawn, LLP*, the plaintiffs were an S-corporation and its two shareholders.<sup>1383</sup> The corporation had a lease for its flagship store that had approximately seven years remaining.<sup>1384</sup> In 2010, the landlord of the premises notified the plaintiffs that it wished to negotiate an early termination and buy-out of the lease.<sup>1385</sup> The defendant law firm was retained to negotiate a buy-out so that the after-tax proceeds to the plaintiff would cover the costs of moving the store to a new location.<sup>1386</sup> The defendant was specifically requested to advise the plaintiffs "of any

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<sup>1377</sup> *Id.*

<sup>1378</sup> *Id.*

<sup>1379</sup> 749 N.W.2d 443, 447 (Neb. 2008). The defendant accountant allegedly told the plaintiff that any taxes on the sale of their property not avoided by means of a section 1031 exchange could be offset by tax credits available to the plaintiffs. *Id.*

<sup>1380</sup> *See id.* at 451–53.

<sup>1381</sup> *Id.* at 453; *See Recovery of Interest, supra* note 43, at 11–12.

<sup>1382</sup> No. 03CV5283DRHWDW, 2006 WL 319303, at \*1 (E.D.N.Y. Feb. 10, 2006); *See infra* text accompanying notes 1482–1486.

<sup>1383</sup> No. 154749/2012, 2013 WL 856559, at \*1 (N.Y. Sup. Ct. Mar. 1, 2013).

<sup>1384</sup> *Id.*

<sup>1385</sup> *Id.*

<sup>1386</sup> *Id.*

and all tax liabilities arising from the buy-out.”<sup>1387</sup> The plaintiffs incurred unexpected New York State and New York City tax liabilities due to differences in how the state, the city, and the federal government tax S-corporations.<sup>1388</sup> The defendant allegedly failed to inform the plaintiffs of these tax liabilities and the plaintiffs brought this action seeking to recover the shortfall caused by the defendant’s error in not negotiating a higher buy-out price that would take these costs into account.<sup>1389</sup>

The defendant’s motion to dismiss the cause of action by the shareholders of the S-Corporation was granted because the retainer clearly provided that the sole client represented was the corporation.<sup>1390</sup> The fact that it was an S-Corporation and its income and expenses flowed through to its shareholders did not matter.<sup>1391</sup> The defendant’s motion to dismiss the corporation’s cause of action was denied.<sup>1392</sup> The court held it was a viable cause of action and the damages sought were not speculative.<sup>1393</sup>

*Delanno, Inc. v. Peace* involved a suit by the purchaser of a business against the attorney who represented him in the purchase transaction.<sup>1394</sup> Under the purchase agreement, the purchaser was not to be responsible for any taxes owed by the acquired business for any time before the date of purchase.<sup>1395</sup> To effectuate this result, the defendant attorney was responsible for obtaining a tax clearance letter from the state, thereby absolving the purchaser of any such tax liability that otherwise would have resulted from the purchase.<sup>1396</sup> The defendant advised the plaintiff that he had obtained the tax clearance letter.<sup>1397</sup> It later came to light that an incorrect tax identification number was used in connection with the tax clearance letter and the purchaser was responsible for pre-sale taxes of the business.<sup>1398</sup> Despite the error, the defendant attorney avoided liability on statute of limitations grounds.<sup>1399</sup>

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<sup>1387</sup> *Id.*

<sup>1388</sup> *Id.*

<sup>1389</sup> *Id.*

<sup>1390</sup> *Id.* at \*4.

<sup>1391</sup> *Id.* at \*3.

<sup>1392</sup> *Id.*

<sup>1393</sup> *Id.*

<sup>1394</sup> 237 S.W.3d 81, 83 (Ark. 2006).

<sup>1395</sup> *Id.*

<sup>1396</sup> *Id.*

<sup>1397</sup> *Id.*

<sup>1398</sup> *Id.*

<sup>1399</sup> *Id.* at 87.

## 6. Method of Accounting

*O'Bryan v. Ashland* involved an accounting error made by the defendant accountant in preparing the plaintiff's tax return for 1995.<sup>1400</sup> The defendant had provided services to the plaintiff since 1987–1988.<sup>1401</sup> In 1995, the plaintiff incorporated his business, following the advice of the defendant, who had recommended this on several occasions over the years.<sup>1402</sup> The business was incorporated on April 1, 1995.<sup>1403</sup> Prior to incorporation, the business utilized the cash method of accounting for tax purposes.<sup>1404</sup> Upon incorporation, the business changed to the accrual method of accounting.<sup>1405</sup> In preparing the business's tax return for 1995, the defendant erroneously used the accrual method of accounting for the first quarter of 1995.<sup>1406</sup> This resulted in a substantial understatement of the business's tax liability.<sup>1407</sup> When the error was discovered several years later, an amended return was filed.<sup>1408</sup> In addition to the extra taxes, approximately \$50,000 of interest was paid.<sup>1409</sup> The plaintiff brought this suit to recover the interest and other expenses incurred to rectify the error.<sup>1410</sup> The defendant conceded his negligence, and the amount of damages was left to the jury.<sup>1411</sup> The jury awarded the plaintiff approximately \$39,000 for interest.<sup>1412</sup> This award of interest was appealed by the defendant.<sup>1413</sup>

On appeal, the South Dakota Supreme Court indicated that the issue of whether such interest is recoverable was a matter of first impression in South Dakota.<sup>1414</sup> The Court ultimately held such interest was recoverable in appropriate circumstances and upheld the jury award.<sup>1415</sup>

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<sup>1400</sup> 717 N.W.2d 632, 633 (S.D. 2006).

<sup>1401</sup> *Id.* at 634.

<sup>1402</sup> *Id.*

<sup>1403</sup> *Id.*

<sup>1404</sup> *Id.*

<sup>1405</sup> *Id.*

<sup>1406</sup> *Id.*

<sup>1407</sup> *Id.*

<sup>1408</sup> *Id.*

<sup>1409</sup> *Id.*

<sup>1410</sup> *Id.*

<sup>1411</sup> *Id.*

<sup>1412</sup> *Id.* at 636.

<sup>1413</sup> *Id.*

<sup>1414</sup> *Id.* at 633.

<sup>1415</sup> *Id.* at 634.

In the United States, there are three views concerning the recovery of such interest. There are two extreme, opposite views and an intermediate, more nuanced view. The majority view is the traditional view that simply permits the recovery of interest as a normal incident of the tort measure of damages.<sup>1416</sup> But for the negligence, the interest would not have been incurred, so it was caused by the negligence and is recoverable.<sup>1417</sup> The opposite view, the minority view, absolutely refuses to permit the recovery of such interest.<sup>1418</sup> According to this view, a plaintiff who incurs this interest had, for some period of time, use of the government's tax money to which he was not entitled.<sup>1419</sup> The interest charge is simply an appropriate charge for this use.<sup>1420</sup> Any recovery of the interest would be a windfall, giving the plaintiff free use of the government's tax money.<sup>1421</sup> The intermediate, and most modern view, permits the recovery of interest when appropriate, which would normally occur when the interest paid the government exceeds the earnings realized by the plaintiff on the tax underpayment.<sup>1422</sup> In *O'Bryan*, the Court emphatically refused to join the minority no-interest-recovery view and instead joined the modern, intermediate view.<sup>1423</sup>

## 7. Stock Redemption

*Apple Bank for Savings v. PricewaterhouseCoopers, LLP* ultimately is simply a situation in which the New York intermediate Appellate Court reversed the trial court and held the statute of limitations barred the asserted cause of action.<sup>1424</sup> Unlike the trial court, the reviewing court held the continuous representation doctrine did not apply to toll the statute of limitations.<sup>1425</sup> The case is worthy of brief focus, however, because the asserted tax error is unusual, involving the interplay of the federal tax provisions governing a bank's bad debt deduction and the stock redemption

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<sup>1416</sup> *Recovery of Interest*, *supra* note 43, at 3.

<sup>1417</sup> *Id.* at 17.

<sup>1418</sup> *Id.* at 4.

<sup>1419</sup> *Id.* at 23.

<sup>1420</sup> *Id.*

<sup>1421</sup> *Id.* at 4, 23.

<sup>1422</sup> *Id.* at 7–8.

<sup>1423</sup> *O'Bryan v. Ashland*, 717 N.W.2d 632, 639–40 (S.D. 2006).

<sup>1424</sup> 895 N.Y.S.2d 361, 362 (App. Div. 2010).

<sup>1425</sup> *Id.*; *See* No. 603492/06, 2009 WL 1363026, at \*4 (N.Y. Sup. Ct. Apr. 14, 2009), *rev'd*, 895 N.Y.S.2d 361 (App. Div. 2010).



rules, and because of certain perceptive analysis in the lower court's unreported, but available, opinion.

In late 1999 or early 2000, the plaintiff, Apple Bank, consulted with the defendant accounting firm as to whether there would be any negative tax consequences under I.R.C. § 593, the provision governing the bank's bad debt deduction, if it entered into a stock redemption agreement with the estate of the bank's deceased sole shareholder.<sup>1426</sup> Apparently, based on the assumption that § 302 of the I.R.C. applied and would treat the redemption as a dividend, the bank was advised there would be no negative tax consequences.<sup>1427</sup> The bank then redeemed additional shares in 2001, 2002, 2003, and 2004.<sup>1428</sup> In 2005, it was discovered that the redemption was not treated as a dividend under I.R.C. § 302, but was treated as a sale by the estate under I.R.C. § 303.<sup>1429</sup> As a consequence, the advice was incorrect, and the redemptions caused the bank to lose a portion of its bad debt deductions for each of the years in which a redemption occurred.<sup>1430</sup> This required filing amended returns, paying over \$12 million in back taxes and interest, and also resulted in the defendant's withdrawing its audit reports for the bank's 2003 and 2004 financial statements.<sup>1431</sup> This suit for damages ensued.

As argued by the defendant in *Apple Bank*, New York law is frequently characterized as not permitting the recovery of back taxes or interest in tax malpractice situations based upon *Alpert v. Shea Gould Clemenko & Casey* and its progeny.<sup>1432</sup> I have argued that *Alpert* is wrong in part, and should be overturned in part.<sup>1433</sup> In the lower court, the judge, rather perceptively in my view, attempted to limit *Alpert* and its progeny so that back taxes and interest may be recoverable where the underlying tax liability could have

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<sup>1426</sup> *Apple Bank*, 2009 WL 1363026, at \*1.

<sup>1427</sup> *See id.* I.R.C. § 302 is the provision governing the tax treatment of corporate redemptions of its outstanding stock. *See* I.R.C. § 302 (2012). Under this provision, assuming the redeeming corporation has adequate earnings and profits, the redemption of stock from a sole shareholder would always be treated as a dividend. *Id.*

<sup>1428</sup> *Apple Bank*, 2009 WL 1363026, at \*1.

<sup>1429</sup> *Id.*; I.R.C. § 303 is an exception to I.R.C. § 302. *See* I.R.C. § 303 (2012); I.R.C. § 302 (2012). It permits non-dividend, sale or exchange treatment under certain circumstances when stock of a decedent is redeemed. I.R.C. § 303 (2012).

<sup>1430</sup> *Apple Bank*, 2009 WL 1363026, at \*1.

<sup>1431</sup> *Id.* at \*2.

<sup>1432</sup> *Id.* at \*5. *See Alpert v. Shea Gould Clemenko & Casey*, 559 N.Y.S.2d 312, 314–15 (App. Div. 1990). *See generally NY: Balanced or Biased*, *supra* note 42.

<sup>1433</sup> *See NY: Balanced or Biased*, *supra* note 42, at 181–82.

been avoided but for the negligently erroneous advice.<sup>1434</sup> The court also cited, with seeming approval, an earlier case, which did allow the recovery of interest on an erroneously caused tax underpayment,<sup>1435</sup> even though that other case seems to have been otherwise invisible, as far as being followed by subsequent cases.<sup>1436</sup>

## 8. Tax Exempt Bonds

In *Coilplus-Alabama, Inc. v. Vann*, the defendant attorney and his law firm were retained in 1998 to advise the plaintiff about the issuance of \$8 million in tax exempt bonds to expand the plaintiff's steel-manufacturing plant.<sup>1437</sup> The bonds were issued in 1999 upon defendant's advice that the bonds qualified for tax exempt status as a small issue under I.R.C. § 144.<sup>1438</sup> Under I.R.C. § 144, the maximum amount of tax exempt bonds that could be issued was \$10 million.<sup>1439</sup> In determining the \$10 million cap, other similar tax exempt bonds that were previously issued and still outstanding had to be included in the cap.<sup>1440</sup> Since the plaintiff had \$5 million of similar previously issued bonds outstanding, the current issue did not qualify for tax exempt status.<sup>1441</sup> When the IRS learned of this in 2001, the plaintiff refunded and retired these bonds as of their date of issue.<sup>1442</sup> On appeal, the Court affirmed the trial court's grant of summary judgment to the defendant on statute of limitations grounds.<sup>1443</sup>

## 9. REMICs

A real estate mortgage investment conduit, or "REMIC," is a type of special purpose tax vehicle utilized for the pooling of mortgage loans and the issuance of securities backed by these loans, (*i.e.*, mortgage-backed

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<sup>1434</sup> *Apple Bank*, 2009 WL 1363026, at \*7.

<sup>1435</sup> *Id.* (citing *Jamie Towers Hous. Co. v. Lucas*, 745 N.Y.S.2d 532 (App. Div. 2002)). *Jamie Towers* involved the underpayment of real estate tax rather than income tax. *Id.* at 533.

<sup>1436</sup> *NY: Balanced on Biased*, *supra* note 42, at 151.

<sup>1437</sup> 53 So. 3d 898, 899 (Ala. 2010).

<sup>1438</sup> *Id.*

<sup>1439</sup> I.R.C. § 144(a)(4) (2012).

<sup>1440</sup> *Id.*

<sup>1441</sup> *Coilplus*, 53 So. 3d at 899.

<sup>1442</sup> *Id.* at 901.

<sup>1443</sup> *Id.* at 909.

securities).<sup>1444</sup> The REMIC itself is not subject to federal income tax.<sup>1445</sup> The type of assets permitted to be owned by a REMIC is limited by the I.R.C.<sup>1446</sup> One type of asset that may be owned is a qualified mortgage which is secured by an interest in real property, the value of which is equal to at least eighty percent of the amount of the mortgage loan.<sup>1447</sup> As a consequence, any transfer of a mortgage loan to a REMIC requires a careful focus on the value of the real property securing the loan to be certain it is adequate to make the loan a qualified mortgage for REMIC purposes.<sup>1448</sup>

The plaintiff in *Nomura Asset Capital Corp. v. Cadwalader, Wickersham & Taft, LLP* had hired the defendant law firm to advise it on an ongoing basis concerning how to comply with the REMIC requirements.<sup>1449</sup> On one pool of loans, the defendant law firm issued an opinion that the package was REMIC-qualified for federal income tax purposes, and included language in the underlying agreement signed by the plaintiff warranting that each loan was a qualified mortgage loan for REMIC purposes.<sup>1450</sup>

One of the loans in this mortgage pool became worthless within three years of the date of an appraisal valuing it at \$68 million.<sup>1451</sup> After litigation, the plaintiff was forced to repurchase this worthless loan for over \$67 million pursuant to its warranty.<sup>1452</sup> It seems the real property securing the loan was not worth near eighty percent of the amount of the loan.<sup>1453</sup> The appraisal of the property securing this loan was questionable on its face, since approximately \$37 million of the \$68 million appraised value was attributable to equipment and intangibles—not real property.<sup>1454</sup> In addition, another relatively contemporaneous appraisal was later discovered that valued the underlying real property for property tax assessment purposes at under \$3 million.<sup>1455</sup>

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<sup>1444</sup> See generally Marshall D. Feiring, 741-2d T.M., REMICs, FASITs and Other Mortgage-Backed Securities. A-1.

<sup>1445</sup> I.R.C. § 860A (2012).

<sup>1446</sup> I.R.C. § 860D(a)(4) (2012).

<sup>1447</sup> *Id.*; I.R.C. § 860G(a)(3)(A) (2012).

<sup>1448</sup> See I.R.C. § 860G(a)(3)(A) (2012).

<sup>1449</sup> No. 116147/06, 2012 N.Y. Misc. LEXIS 2161, at \*3 (Sup. Ct. Jan. 11, 2012).

<sup>1450</sup> *Id.* at \*6.

<sup>1451</sup> *Id.* at \*7.

<sup>1452</sup> *Id.* at \*12.

<sup>1453</sup> See *id.*

<sup>1454</sup> *Id.* at \*5.

<sup>1455</sup> *Id.* at \*8–9.

This action ensued, in which the plaintiff asserted the defendant was to blame for the loss because (1) it did not properly advise the plaintiff concerning the requirements for appraisals that were necessary to establish that a mortgage loan was qualified property for a REMIC; and (2) because it did not properly perform the necessary due diligence requisite to issuing its opinion that this pool of mortgage loans was REMIC-qualified since it did not review the appraisal for this loan.<sup>1456</sup> In response, the defendant asserted it relied on the expertise of the plaintiff's mortgage bankers concerning property valuations.<sup>1457</sup> In *Nomura*, the court denied the defendant's motion for summary judgment because many factual issues remained to be decided.<sup>1458</sup>

### 10. Miscellaneous

There are several cases that mention seemingly viable tax malpractice claims, but which do not explore the underlying facts in meaningful detail and which were decided on non-substantive grounds. These cases are presented in tabular form.

Case Name	Tax Malpractice Claim	Disposition
<i>Burtoff v. Faris</i> <sup>1459</sup>	Defendant negligently drafted and implemented a disclaimer of an inheritance. <sup>1460</sup>	Claim barred by statute of limitations. <sup>1461</sup>
<i>Diamond Island Marina, Inc. v. Grabel, Schnieders, Hollman &amp; Co.</i> <sup>1462</sup>	Incorrect advice by accountant that transfer of property to the mortgagee bank would not have negative tax consequences. <sup>1463</sup> This apparently implicates cancellation of indebtedness income and I.R.C. § 108. <sup>1464</sup>	Defendant's motion for summary judgment denied. <sup>1465</sup> There are triable issues of fact. <sup>1466</sup>

<sup>1456</sup> *Id.* at \*13.

<sup>1457</sup> *Id.* at \*36.

<sup>1458</sup> *Id.* at \*65–66.

<sup>1459</sup> 935 A.2d 1086 (D.C. Cir. 2007).

<sup>1460</sup> *Id.* at 1088.

<sup>1461</sup> *Id.* at 1090.

<sup>1462</sup> No. 08–0025–DRH, 2009 WL 3769775 (S.D. Ill. Nov. 10, 2009).

<sup>1463</sup> *Id.* at \*1.

<sup>1464</sup> I.R.C. § 108 (2012).

<sup>1465</sup> *Diamond Island*, 2009 WL 3769775, at \*2.

<i>GUS Consulting GmbH v. Chadbourne &amp; Parke, LLP</i> <sup>1467</sup>	Defendant attorneys failed to advise plaintiff it was illegal under Russian law to invest in a Russian natural gas company by means of a simple partnership structure. <sup>1468</sup>	Summary judgment for defendant affirmed because of a prior arbitration and because no admissible evidence about proximate cause was introduced. <sup>1469</sup>
<i>Kay v. McGuire Woods, LLP</i> <sup>1470</sup>	Incorrect advice from attorney as to structure of sale of stock in a business, <sup>1471</sup> and failing to give adequate information to allow plaintiff to make an informed decision. <sup>1472</sup>	Case remanded back to state court. <sup>1473</sup>
<i>Morrow Cash Heating &amp; Air, Inc. v. Jackson</i> <sup>1474</sup>	Accountant sued client for unpaid fees. <sup>1475</sup> Client countersued asserting accountant gave wrong advice not to collect sales tax on equipment installed in new construction. <sup>1476</sup>	Directed verdict for accountant on counterclaim reversed. <sup>1477</sup> There was a bona fide issue whether the statute of limitations had run. <sup>1478</sup>
<i>Osowski v. Howard</i> <sup>1479</sup>	Defendant accountant who acted only as a return preparer for plaintiff and her business failed to inform her that her sons had taken the business from her when they incorporated the	Court affirmed summary judgment for defendant since defendant owed no duty to inform plaintiff and also on statute of limitation

<sup>1466</sup> *Id.*<sup>1467</sup> 905 N.Y.S.2d 158 (App. Div. 2010).<sup>1468</sup> *Id.* at 159.<sup>1469</sup> *Id.* at 159–60.<sup>1470</sup> No. 2:11-cv-00341, 2012 WL 1067555 (S.D. W. Va. Mar. 28, 2012).<sup>1471</sup> *Id.* at \*1.<sup>1472</sup> *Id.* at \*3.<sup>1473</sup> *Id.* at \*5.<sup>1474</sup> 239 S.W.3d 8 (Ark. 2006).<sup>1475</sup> *Id.* at 9.<sup>1476</sup> *Id.*<sup>1477</sup> *Id.* at 9–10.<sup>1478</sup> *Id.* at 10.<sup>1479</sup> No. 2010AP2260, 2011 WI App 155 (Wis. Ct. App. Oct. 18, 2011).

	business that was previously a partnership. <sup>1480</sup>	grounds. <sup>1481</sup>
<i>Sanders v. Bressler, Amery &amp; Ross, P.C.</i> <sup>1482</sup>	Defendant attorney failed to timely obtain an agreement with the Environmental Protection Agency thereby preventing the tax free sale of a property/purchase of another property to qualify for tax free treatment under I.R.C. § 1031. <sup>1483</sup>	Defendant's motion to dismiss granted. <sup>1484</sup> As spouses and children of the owners of the property involved, they had no privity to bring malpractice cause of action. <sup>1485</sup> They also were not third party beneficiaries entitled to bring a breach of contract action. <sup>1486</sup>
<i>Sonicblue, Inc. v. Pillsbury Winthrop Shaw Pittman, LLP</i> <sup>1487</sup>	Counsel for bankrupt corporation failed to inform bankrupt corporation that it need to file timely tax returns. <sup>1488</sup>	Defendant's motion to dismiss denied. <sup>1489</sup>
<i>Trolly Corp. v. Boohaker</i> <sup>1490</sup>	Adverse tax consequences resulted from how the defendant attorney structured a transaction in which two investors bought into plaintiff and an earlier investor was bought out. <sup>1491</sup>	Affirms summary judgment to defendant on statute of limitations grounds. <sup>1492</sup>

<sup>1480</sup> *Id.* at \*2.

<sup>1481</sup> *Id.* at \*5, \*7.

<sup>1482</sup> No. 03CV5283DRHWDW, 2006 WL 319303 (E.D.N.Y. Feb. 10, 2006).

<sup>1483</sup> *Id.* at \*1. The basic mechanics of I.R.C. § 1031 are described *supra* text accompanying notes 1292–1294.

<sup>1484</sup> *Sanders*, 2006 WL 319303, at \*6.

<sup>1485</sup> *Id.*

<sup>1486</sup> *Id.* at \*7.

<sup>1487</sup> Bankruptcy No. 03–51775–MM, 2008 WL 2875407 (Bankr. N.D. Cal. July 23, 2008).

<sup>1488</sup> *Id.* at \*8.

<sup>1489</sup> *Id.* at \*13.

<sup>1490</sup> 938 So. 2d 157 (La. Ct. App. 2006).

<sup>1491</sup> *Id.* at 159.

<sup>1492</sup> *Id.* at 161.

Before concluding this section, I wish to take note of two cases that I think of as “oddball” but that may be worth brief mention. *Holtkamp v. Parklex Associates* is part of an extended dispute between the limited partners and the general partner in a partnership that owned a valuable parcel of real property.<sup>1493</sup> The gist of the dispute is a claim by certain partners that the general partner and others colluded to defraud the plaintiffs of their rightful portion of the proceeds from the sale of the property.<sup>1494</sup> Among the allegations are assertions of fraudulent tax returns prepared by certain accountants with assistance or participation of certain attorney defendants.<sup>1495</sup> It is uncertain, though, whether these returns were actually filed or whether they were simply shown to or given to the plaintiffs but never filed.<sup>1496</sup>

*Sorenson v. H & R Block, Inc.* is a case I previously characterized as diabolically fascinating<sup>1497</sup> and it continues to fulfill this description.<sup>1498</sup> The original case involved a suit against defendant H & R Block and one of its employees seeking \$5 million in damages.<sup>1499</sup> The gist of the complaint was that the employee allegedly contacted the tax authorities before the plaintiff’s tax return was filed and notified them the plaintiff would be filing incorrect 1993 income tax returns.<sup>1500</sup> On the ensuing audit, the employee also allegedly voluntarily gave the tax auditor internal H & R Block documents suggesting the return was fraudulent.<sup>1501</sup> Subsequently, both the IRS and Massachusetts audited the plaintiffs for several tax years.<sup>1502</sup> A criminal investigation by the IRS also ensued.<sup>1503</sup> Although many causes of action were asserted,<sup>1504</sup> the plaintiffs were successful only on a breach of contract claim, and for a rather technical violation of the Massachusetts False and Deceptive Trade Practices Act.<sup>1505</sup> The total

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<sup>1493</sup>No. 14514/2006, 2011 WL 621122, at \*1 (N.Y. Sup. Ct. Feb. 22, 2011).

<sup>1494</sup>*See id.* at \*2.

<sup>1495</sup>*Id.* at \*3.

<sup>1496</sup>*See id.* at \*3, \*11, \*12.

<sup>1497</sup>*Malpractice II, supra* note 1 at 1025.

<sup>1498</sup>*See generally* NO. 99-10268-DPW, 2002 U.S. Dist. LEXIS 18689 (D. Mass. Aug. 27, 2002), *aff’d*, 107 F. App’x 227 (1st Cir. 2004).

<sup>1499</sup>*Id.* at \*2.

<sup>1500</sup>*Id.* at \*11–12.

<sup>1501</sup>*Id.* at \*12.

<sup>1502</sup>*Id.* at \*8, \*10.

<sup>1503</sup>*Id.* at \*11.

<sup>1504</sup>*Id.* at \*3–4.

<sup>1505</sup>*Id.* at \*61.

damages recovered by the plaintiffs was \$630.<sup>1506</sup> Under the Massachusetts False and Deceptive Trade Practices Act, the plaintiffs were also entitled to attorney's fees.<sup>1507</sup> In the most recent case, the plaintiffs sought attorney's fees and costs totaling over \$180,000.<sup>1508</sup> The court, however, only awarded them \$18,900.<sup>1509</sup> Diabolically fascinating indeed!

#### IV. CONCLUSION

The most notable developments in the decade examined occurred in the generic tax shelter area. Government data indicates that many thousands of tax shelter products were sold.<sup>1510</sup> However, apart from the several class actions that have been settled,<sup>1511</sup> which did not supply useful substantive input for this article, I quickly realized that most of the reported cases dealt with procedural matters, which, while interesting and illuminating regarding how these products were marketed and effectuated, again did not supply useful input. It seems highly probable that redress for many of the "victimized" purchasers of ineffective shelters was determined by arbitration or unreported decisions. Paradoxically, during most of the rather long gestation period for this article, I was left with only a handful of cases that even touched on substantive issues.<sup>1512</sup> Towards the end of the process, along came the rather prodigious *Yung v. Grant Thornton, LLP*, which finally reached a judgment on the merits.<sup>1513</sup>

*Yung*, while very significant, especially as long as it remains the only case to reach the merits, may not yet be the final word. First, there is the matter of an appeal. Especially in light of the magnitude of the punitive damages, an appeal is likely. While the judge spent many pages illustrating the egregious conduct of the defendant and justifying the size of the punitive damages awarded, \$80 million of punitive damages and punitive damages equal to four times the compensatory damages, might simply be

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<sup>1506</sup>NO. 99-10268-DPW, 2005 U.S. Dist. LEXIS 23590, at \*1 (D. Mass. Sept. 1, 2005).

<sup>1507</sup>*Id.* at \*3-4.

<sup>1508</sup>*Id.* at \*1.

<sup>1509</sup>*Id.*

<sup>1510</sup>*See supra* note 7.

<sup>1511</sup>*See supra* note 14.

<sup>1512</sup>*See supra* Part II. D. Apart from *Yung v. Grant Thornton, LLP*, No. 07-CI-2647 (Ky. Cir. Ct. Nov. 8, 2013) available at <http://www.woodllp.com/Publications/Articles/pdf/Yung.pdf> (not designated for publication).

<sup>1513</sup>*See Yung*, No. 07-CI-2647, at \*209.



too much for an appellate court to accept.<sup>1514</sup> Similarly, the trial judge's invalidation of the engagement letter's attempt to limit damages to the \$900,000 fee paid, while most logical, and seemingly correct, might be a weak point on appeal.<sup>1515</sup> The compensatory damages seem mostly noncontroversial, except with respect to the interest of a little over \$5 million awarded.<sup>1516</sup> As occurred in *Amato v. KPMG, LLP*,<sup>1517</sup> the court treated the award of interest as rather mechanical, and failed to appreciate the three approaches to awarding interest currently extant.<sup>1517</sup> But, if challenged on appeal, the court could simply be seen as following the traditional majority view on this issue,<sup>1518</sup> though without explicitly focusing on it.

*Yung* is totally fascinating both in how meticulously and extensively the court recounted the repetitive egregious conduct of the defendant, and in how the court responded with its compensatory and punitive damage awards. It should be remembered, however, that *Yung* involved very extreme and egregious facts—the defendant was selling a product that was not yet fully thought through or developed and which, in fact, was totally flawed, while at the very same time promising a very conservative and careful taxpayer that the product was 100 percent kosher.<sup>1519</sup> In addition, the existence of the e-mail evidence documenting exactly who did what and when is most significant in that the facts were definitively established beyond any peradventure.<sup>1520</sup> Other similar situations very likely may not enjoy this level of factual certainty.

As indicated in Part II, E above, where an attorney or accountant who really was part of the group which developed a shelter or who was otherwise part of the group selling the shelter and this fact was hidden so that he or she was portrayed as an independent professional, liability should be reasonably certain to ensue.<sup>1521</sup> The precise ground for liability—*i.e.*, fraud, misrepresentation, breach of fiduciary duty, negligence, perhaps

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<sup>1514</sup> See *id.* at \*194–209.

<sup>1515</sup> See *id.* at \*191.

<sup>1516</sup> See *id.* at \*210.

<sup>1517</sup> See No. 06cv39, 2006 U.S. Dist. LEXIS 57091, at \*8 (M.D. Pa. Aug. 14, 2006). The court's brief consideration of whether the amount of damages was liquidated so as to support an award of interest, seemed, if anything, to be inconsequential. See *Yung*, No. 07-CI-2647, at \*176–77.

<sup>1518</sup> In my survey of the recoverability of interest on a tax underpayment, I did not find any explicit precedent in Kentucky. See *Recovery of Interest*, *supra* note 43, at 30.

<sup>1519</sup> See generally *Yung*, No. 07-CI-2647.

<sup>1520</sup> See generally *id.*

<sup>1521</sup> See *supra* Part III. E.

RICO—may differ depending on the precise facts involved and the jurisdiction. It would seem liability is much less certain when the advisor functioned in the traditional role of the disinterested advisor. If a taxpayer retains such a tax professional to advise about the efficacy of a tax shelter product and the advisor errs and issues an opinion that the shelter is more-likely-than-not-valid, will liability ultimately be imposed on the advisor? What about the error in judgment rule?—at least where the error was not egregious? What about the intrinsic weakness of a more-likely-than-not opinion, the lowest threshold of an acceptable opinion? Hopefully, some authority will address these issues soon.

During this past decade a number of cases have arisen in the benefit plan area. These cases really are very similar to the generic tax shelter cases. Many benefit plans that were too good to be true were developed and sold as valid benefit plans. These situations, like the generic tax shelters, were marketed to individual business owners who likely knew or sensed they were really shelters rather than legitimate benefit plans. But, being in a decade of excesses, where people would try almost anything to avoid taxes especially where there was some facially valid imprimatur of legality, these plans abounded. While these situations could easily have been characterized as a type of generic tax shelter, they were treated separately herein because they typically involved a specific IRC section and so could easily be categorized by code section. Here, as with the generic tax shelters, many players who seemed blameworthy and who should have been found liable, avoided responsibility on statute of limitations and other non-substantive grounds.<sup>1522</sup>

As in my past studies, the specific areas that seem to have generated the most cases are the estate planning/estate and gift tax area and the late filing/non-filing and negligent preparation areas.<sup>1523</sup> There still seems to be a rather steady stream of cases involving planning or drafting errors in the estate planning area.<sup>1524</sup> In the late filing/non-filing and negligent preparation areas, the errors typically involve a more general type of sloppiness or inattentiveness rather than “tax” errors.<sup>1525</sup> Beyond these, the errors seem to cover many different areas of tax practice, which do not lend themselves to ranking.

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<sup>1522</sup> See *supra* Part III. E.1.

<sup>1523</sup> *Malpractice I*, *supra* note 1, at 641-42; *Malpractice II*, *supra* note 1, at 1089-90.

<sup>1524</sup> See *supra* Part III. D.2.

<sup>1525</sup> See *supra* Parts III. B.1 and 2.

In the generic tax shelter area, the holdings in *Carroll v. LeBoeuf, Lamb, Greene & MacRae, LLP* and *Rosenbach v. The Diversified Group, Inc.* are noteworthy and surprising.<sup>1526</sup> *Carroll* held that the purchasers of an ineffective generic tax shelter could not prove they suffered any damages caused by the promoter of the shelter because they had amended their original return on which the shelter deduction was claimed and paid the additional taxes and interest.<sup>1527</sup> This goes against the well-established principle of mitigation of damages. It punishes the plaintiffs who acted responsibly and sought to limit their damages.

In *Rosenbach*, the defendants who sold the plaintiffs an ineffective generic tax shelter sought contribution from the plaintiffs' tax counsel and plaintiffs' accounting firm that prepared the return on which the shelter loss was reported.<sup>1528</sup> The defendants asserted that the tax counsel erred in advising the plaintiffs whether to apply for amnesty.<sup>1529</sup> They also asserted that the accounting firm lacked a reasonable basis for reporting the shelter loss on the plaintiffs' tax return.<sup>1530</sup> While it seems ludicrous and the height of "chutzpah" for the seller of a bad tax shelter who repeatedly vouched for the efficacy of the shelter to claim the plaintiffs' return preparer should have known better than to believe him, the court upheld the denial of the motions to dismiss the third part claims brought by the plaintiffs' tax counsel and accounting firm.<sup>1531</sup>

Finally, *Penner v. Hoffberg, Oberfest, Burger & Berger* answers a longstanding question in the tax malpractice area: whether any recovery is available when a tax advisor makes an error that triggers an audit that uncovers other unrelated tax deficiencies?<sup>1532</sup> The court answered no!<sup>1533</sup> It held that a plaintiff is not entitled to recover the cost of defending an audit where there is no evidence that any erroneously reported item created a tax liability that would not otherwise have existed.<sup>1534</sup>

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<sup>1526</sup> *Carroll*, 623 F. Supp. 2d 504 (S.D.N.Y. 2009); *Rosenbach*, 926 N.Y.S.2d 49 (App. Div. 2011); see *supra* text accompanying notes 192–199; and notes 186–191.

<sup>1527</sup> *Carroll*, 623 F. Supp. 2d at 513.

<sup>1528</sup> *Rosenbach*, 926 N.Y.S.2d at 49.

<sup>1529</sup> *Id.* at 52.

<sup>1530</sup> *Id.*

<sup>1531</sup> *Id.* at 51.

<sup>1532</sup> 844 N.Y.S.2d 229, 230 (App. Div. 2007); see *supra* text accompanying notes 676–685.

<sup>1533</sup> *Id.*

<sup>1534</sup> *Id.* at 554.