

31st Annual
Tax Symposium

**ACCOUNTING MALPRACTICE LITIGATION:
WHAT YOU (HOPEFULLY NEVER)
NEED TO KNOW**

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ACCOUNTING MALPRACTICE LITIGATION: WHAT YOU (HOPEFULLY NEVER) NEED TO KNOW

- Anatomy of Professional Liability Litigation
- Retention Agreements and the Statute of Limitations
- Common Liability Issues: Standard of Care and Comparative Fault
- Common Damages Issues: Tax Liability and Interest

ANATOMY OF PROFESSIONAL LIABILITY LITIGATION

- Liability of CPAs is limited to statutory actions under MCL 600. 600.2962 Malpractice action against certified public accountant.
- CPAs can be sued for intentional misrepresentation or fraud.
- CPAs can be sued by clients or by intended beneficiaries for negligent acts or omissions .

ANATOMY OF PROFESSIONAL LIABILITY LITIGATION

- Claims of negligence against accountants are governed by the common law elements of professional malpractice.
- A plaintiff must prove (1) that the plaintiff was either a professional client or intended beneficiary; (2) negligence in the performance of professional duties; (3) causation; and (4) the fact and extent of injury.

RETENTION AGREEMENTS AND STATUTE OF LIMITATIONS

- The statute of limitations for an action of malpractice is two years EXCEPT a plaintiff may file a malpractice complaint within six months after the plaintiff discovers or should have discovered the existence of the claim.
- The two-year period begins at the time that the accountant discontinues serving the plaintiff in a professional capacity as to the matters out of which the claim for malpractice arose.

RETENTION AGREEMENTS AND STATUTE OF LIMITATIONS

Levy v Martin, 463 Mich 478 (2001)

- From 1974 until 1996, defendant accountants prepared the annual tax returns of plaintiff dentist.
- After audit, IRS required dentist to pay additional taxes for 1991 and 1992, as well as penalties and interest.
- In August 1997, dentist sued for accounting malpractice.

RETENTION AGREEMENTS AND STATUTE OF LIMITATIONS

Levy v Martin, 463 Mich 478 (2001)

- The accountants moved to dismiss, noting that the tax returns had been prepared and submitted in 1992 and 1993. They argued that 1997 complaint was too late.
- The dentist argued that the accountant-client relationship continued into 1996, within two years of 1997 complaint.

RETENTION AGREEMENTS AND STATUTE OF LIMITATIONS

Levy v Martin, 463 Mich 478 (2001)

- Court – “A client who entrusts preparation of annual tax returns to an accountant is provided with an assurance of professional preparation of the tax returns that induces the client to take no further action regarding those matters until it is time to prepare the next year's tax returns.”
- Complaint timely because relationship continued into 1996.

RETENTION AGREEMENTS AND STATUTE OF LIMITATIONS

JGM Transportation, Inc v Lewis & Knopf CPAs, 2015 WL 773707 (Mich App, 2015) (unpublished)

- In 2008, defendant accountants agreed to provide accounting services for plaintiff transportation company.
- 2009 invoice for 2008 return stated, “This Concludes our Engagement for the Preparation of Your 2009 Financial Statements and Tax Returns.”

RETENTION AGREEMENTS AND STATUTE OF LIMITATIONS

JGM Transportation, Inc v Lewis & Knopf CPAs, 2015 WL 773707 (Mich App, 2015) (unpublished)

- Accountants argued that 2012 complaint was too late because it was filed more than two years after the invoice said that the professional relationship had ended.
- Transportation company said 2012 complaint was timely because accountants discussed audit in 2011 and allegedly admitted a mistake.

RETENTION AGREEMENTS AND STATUTE OF LIMITATIONS

JGM Transportation, Inc v Lewis & Knopf CPAs (2015)
(unpublished)

- Court – accountants “structured the tax preparation services as discrete transactions that ended with its written notice that the engagement had been concluded.”
- Contact during audit period were not professional services because accountants were not retained, and conversation was administrative or ministerial.

RETENTION AGREEMENTS AND STATUTE OF LIMITATIONS

Takeaways

- Retention agreements and invoices can structure representation to be discrete transactions rather than ongoing and generalized tax services.
- Assistance during audit is a business decision, but may revive a malpractice claim that would otherwise be barred.
- Even if two years has run, a client or former client still has six months from discovery (often the IRS deficiency notice).

COMMON LIABILITY ISSUES: STANDARD OF CARE AND COMPARATIVE FAULT

- To prove negligence, plaintiff must show that accountant did not exercise “the skill and care ordinarily possessed and exercised by practitioners of the profession in the same or similar localities.”
- Expert testimony is necessary unless the lack of professional care is so obvious as to be within the common knowledge and experience of an ordinary layperson.

COMMON LIABILITY ISSUES: STANDARD OF CARE AND COMPARATIVE FAULT

United States v Red Stripe, Inc, 792 F Supp 1338, 1345 (EDNY 1992)

- “One’s duty to pay taxes cannot be circumvented merely by alleging that another party is contractually obligated to fulfill those responsibilities. [A taxpayer’s] lack of ordinary business care and prudence cannot be salvaged by claiming that he relied on the advice of his attorneys and accountants.”

COMMON LIABILITY ISSUES: STANDARD OF CARE AND COMPARATIVE FAULT

31 C.F.R. § 10.34(d)

- A tax preparer generally may rely in good faith without verification upon information furnished by the client.
- However, the practitioner may not ignore implications of the information, and must make reasonable inquiry if the information appears incorrect, inconsistent, or incomplete.

COMMON LIABILITY ISSUES: STANDARD OF CARE AND COMPARATIVE FAULT

Takeaways

- Accountants are held to the standard of a reasonable practitioner, and clients also have a duty to act reasonably.
- Accountants can rely on information from client unless incorrect, inconsistent, or incomplete.

COMMON DAMAGES ISSUES: TAX LIABILITY AND INTEREST

Are taxes assessed in a deficiency a proper element of damages in an accounting malpractice case?

No. The amount of a tax deficiency is not the measure of damages imputable to a negligent tax preparer. *Miller v Volk*, 63 Mass App 303 (2005).

Back taxes are not recoverable because they are payments rightfully due to the IRS. *Olenicoff v UBS AG*, 2012 WL 1192911 (CD Cal, 2012).

Recovery of back taxes would place investors in better position than before tax opinion. *Alpert v Shea Gould Climenko & Casey*, 160 AD2d 67 (NY App, 1990).

COMMON DAMAGES ISSUES: TAX LIABILITY AND INTEREST

Are taxes assessed in a deficiency a proper element of damages in an accounting malpractice case?

Yes. Tax liability can be recovered to the extent that taxes would have been avoided through required advice. *Eckert Cold Storage, Inc v Behl*, 943 F Supp 1230 (ED Cal, 1996).

Measure of damages is difference between what taxpayer would have owed absent negligent advice and what they actually paid. *DDRA Capital, Inc v KPMG*, 2018 WL 924204 (D VI, 2018).

COMMON DAMAGES ISSUES: TAX LIABILITY AND INTEREST

Michigan has not formally decided this issue

- Court said in *CJ Enterprises, Ltd v Rattenbury & Assocs, Inc*, 1996 WL 33324081 (Mich App, 1996) (unpublished) – “plaintiffs, as taxpayers, were at all times liable for any lawfully due tax.”
- Plaintiffs representing taxpayers will argue that *CJ Enterprises* is not binding, and was deciding a statute of limitations issue.

COMMON DAMAGES ISSUES: TAX LIABILITY AND INTEREST

Can a taxpayer recover IRS interest in a malpractice case?

No. Plaintiffs had value of the use of money and would be unjustly enriched to recover that interest from another source. *Leendertsen v Price Waterhouse*, 81 Wash App 762 (1996).

Yes. Interest not recoverable only if the IRS charged a market rate of interest. *Stone v Kirk*, 8 F3d 1079 (CA 6, 1993); see also *O'Bryan v Ashland*, 717 NW2d 632 (SD, 2006).

COMMON DAMAGES ISSUES: TAX LIABILITY AND INTEREST

Takeaways

Back taxes probably not recoverable if they would have been owed if the tax returns had been prepared properly.

Open issue if avoidable back taxes can be recovered.

Interest assessments probably not recoverable, particularly to the extent IRS charges market rate of interest.

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THANK YOU



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