

2-1-1950

The Single-Standard Concept of Civil Liability in the Preparation of a Tax Return

Wirt Peters

Follow this and additional works at: <https://repository.law.miami.edu/umlr>

Recommended Citation

Wirt Peters, *The Single-Standard Concept of Civil Liability in the Preparation of a Tax Return*, 4 U. Miami L. Rev. 154 (1950)

Available at: <https://repository.law.miami.edu/umlr/vol4/iss2/3>

This Article is brought to you for free and open access by the Journals at University of Miami School of Law Institutional Repository. It has been accepted for inclusion in University of Miami Law Review by an authorized editor of University of Miami School of Law Institutional Repository. For more information, please contact library@law.miami.edu.

THE SINGLE-STANDARD CONCEPT OF CIVIL LIABILITY IN THE PREPARATION OF A TAX RETURN

WIRT PETERS *

If ever there was a field of human endeavor where a little knowledge is a dangerous thing, that field is taxation. And yet, there probably is no other field in which so many persons believe themselves to be skilled with so little training or experience. This possibly can be accounted for by three circumstances: first, most of those who assist with the preparation of a tax return neither realize nor recognize the hazard of civil liability and are blithely unaware of the responsibility they have unwittingly assumed. Second, the damage they do to their clients is seldom obvious, and the practical probabilities are in favor of its never becoming apparent. Third, most taxpayers themselves do not realize the nature or extent of their rights against those who erroneously prepare their tax returns for them.

It seems apparent from the multifarious abilities of the individuals operating as qualified in the tax field that there must be a widespread misconception of the nature of their responsibilities. Accordingly, without offering any evidence at this point, nor attempting to answer any objections, the first proposition compelled by our thesis should be definitely stated as,

Every person who for a fee assists in the preparation of a tax return is equally liable as any other person under the same circumstances regardless of his professional qualifications, whether he be an attorney, a certified public accountant, or a "drug store tax expert."

Within the sphere of liability, then, is the attorney, the accountant, and every other person who holds himself out to the public as being available for assisting in the preparation of a tax return. Any person who advertises, "Free Lunch with Each Tax Return," "Tax Returns Expertly Made for \$2.00," or simply "Income Tax," thereby represents that he is familiar with the requirements of the revenue law for the making and filing of a return. Anyone who accepts the responsibility for the preparation of a return, even if merely filling in the spaces with figures furnished by the client, thereby concurrently assumes this uniform liability to exercise the same standard of care for the accurate and proper accomplishment of his employment as would be required of any other person regardless of his professional qualifications. For convenience of identification, any member of this group indiscriminately shall be referred to as the *adviser*.

* Professor of Law, University of Miami. Attorney and Certified Public Accountant of Oklahoma and Illinois.

In directing attention to the liability, it would be natural to find the adviser immediately insisting that his responsibility depended upon the manner in which he obtained the information for the preparation of the return, that is, whether it had been furnished directly by the taxpayer, whether he had access to the records for a so-called tax examination, or whether he had been employed to make such audit as was necessary to secure his own information. However, liability is correlated to duty; the extent of the liability may bear a direct relation to the extent or scope of the employment, but the nature of the duty is the same in every instance. In each case there exists a duty to properly accomplish a required result and to compensate the client for all financial damage caused by an inadequate performance. This proposition, too, should be definitely presented, as

Every adviser assumes the responsibility for the preparation of an accurate, true, and complete return from the information of which he has any knowledge, or which he could have reasonably ascertained from the data available at the time.¹

It is unnecessary to belabor the problem of what constitutes an "accurate, true, and complete return" in those circumstances where there may be a reasonable basis for interpretation and the exercise of informed judgment. In developing principles it is preferable to use simple illustrations, for having established a principle in an elementary situation it will not be upset merely because the circumstances become more complex.

Suppose, to begin, that the taxpayer sought the adviser to have him prepare the return solely in the capacity of an amanuensis, all of the figures being supplied and the amount of tax already computed. The duty of the adviser would be simply to fill in the form acceptably, there would be no liability for errors in the information, in the use of the figures, nor in the calculations. No one would claim that a variety of liabilities should result depending upon the professional qualifications of the adviser involved, this provided, of course, that both the client and the adviser fully understood the nature of their relationship. It should be especially noted, however, that the adviser who advertises tax assistance, and who prepares the return from information furnished by the client but elicited by questions from the adviser, can not thereafter escape liability by claiming he was acting merely as an automaton without assuming any duty toward the client.

Considering the next most obvious and least argumentative situation, suppose the error on the return is merely mathematical, and the correction results in a subsequent assessment of tax which would have had to have been paid originally if the return had been correctly prepared, but there is also now some interest to be paid. Could it possibly be argued that if the adviser is a certified public accountant he would be liable for the amount of the interest

1. GCM 14509, CB June, 1935, p. 84.

which he has erroneously caused the client to have to pay, but if the adviser is only a "\$2.00 expert" he would not be liable?

Assume that after inquiring about the amount of income and the exemptions, the adviser automatically uses the "short-form" return and determines from the tax-table a liability of several hundred dollars. It later develops that the taxpayer actually had suffered hurricane damage in an amount which would have completely eliminated all tax if the deduction had been properly claimed. If this is discovered at a time when it is impossible to secure a refund, the taxpayer has suffered a determinable financial damage attributable directly to either the negligence or lack of adequate knowledge on the part of the adviser. It could not possibly be maintained by any attorney or certified public accountant that he should not be liable under these circumstances to compensate the client for the damage sustained by the failure to enquire about the specific deductions, the information could have reasonably been ascertained at the time of preparing the return. Then, is the lay expert who has held himself out as being possessed of the requisite knowledge of the applicable rules, laws, and regulations, and has accepted employment for the preparation of the tax return in accordance with them, to be permitted to escape liability for his nonobservance of them by pleading that he had no knowledge of the storm damage and that the return was prepared from information submitted by the taxpayer who did not disclose this deductible item?

Alexander C. Howe² had dividend income from Canadian corporations. The net amount received was reported in his return, no showing being made as to the foreign taxes withheld because the person who made the return, a secretary in the legal firm handling the affairs of the taxpayer, did not realize that a better tax advantage could be had by reporting the gross dividends and claiming a direct credit for the foreign tax withheld. Later an amended return was filed claiming the credit which the Commissioner refused to allow. The Board, sustaining the Commissioner, said that the reporting of the net receipts was in effect an exercise of the option to claim the foreign tax as a deduction instead of a credit, and the election could not be changed after the due date for filing the return. The taxpayer paid a heavy price for the lack of knowledge of the one represented as skilled in the preparation of tax returns. The reports are full of these kinds of cases, but the most interesting part of the story is never disclosed: What settlement is made with the client by the one who prepared the return? I have no doubt that the adviser does not escape liability on the ground that the taxpayer failed to make known to the adviser the proper method of claiming deductions or credits.

Then, there is the case of Edward H. Clark³ in which the adviser in computing the net income first deducted the full amount of a capital loss, although

2. *Alexander C. Howe v. Commissioner of Internal Revenue*, 44 BTA 894.

3. *Edward H. Clark v. Commissioner of Internal Revenue*, 40 BTA 333.

only a percentage of the loss was allowable, and then filed a joint return for the taxpayer and his wife instead of separate returns which were then permissible by California taxpayers because of the community property laws of that State. Upon the adjustment of the net income a large overpayment of tax was required which could not be corrected because of the conclusive election to file a joint return. The adviser paid the taxpayer the sum of \$19,941.10 as the amount of the damage caused by his error. The Commissioner attempted to tax this amount as income to the client, but the Board assumed, without citation, that the adviser "became legally obligated to and did pay because of that negligence" the damage he had caused, and held that it was not income to Clark but compensation for an actual loss.

The reports are understandably barren of damage actions involving advisers; there are no reported cases directly on our point,⁴ as no firm could well afford the resulting publicity. But every tax counsel knows within his own experience of such cases. Generally voluntary settlements are reached, or the cases are not appealed beyond the inferior court. The reports are almost ominously silent. This is a wide and dangerous area in which there are no established boundaries and no charted courses. Those who have traveled this way—and there must have been many—have left no log of their experiences to guide those who will come after. It will be necessary to draw our conclusions from analogies and base them upon general propositions of law.

How, then, is it to be determined whether there has been negligence or lack of knowledge in the preparation of a tax return? It is well settled jurisprudence that a member of a learned profession must possess such professional knowledge, skill, and qualifications, and exercise such care and diligence in matters of professional employment as is expected and required by the profession of its members generally. Failure to measure up to such professional standards makes him liable to his client for all damages which result.⁵ Accountants, too, constitute a skilled professional class and are subject, generally, to the same rules of liability for negligence or lack of knowledge in the practice of their profession as are the members of the other professions,⁶ and many excellent articles⁷ have been written accumulating the citations upon their analogous liability. And, of course, the general liability of agents needs hardly to be mentioned.

Without indulging in any of the disputes between the professions, or becoming involved in a dialectical argument as to what constitutes the practice

4. Acknowledgment is made of the research assistance and cooperation of Mr. David B. Chase of J. K. Lasser and Co., New York.

5. 5 Am. Jur. 333.

6. See Note, 74 A.L.R. 1153; 10 Am. Jur. 520.

7. See particularly BORIS KOSTELANETZ, AUDITOR'S RESPONSIBILITIES AND THE LAW; XIX, No. 2 THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT 91 (1949); R. M. Lewis, *What is Competent Tax Advice*, THE TAX MAGAZINE (Jan. 1950); 42 MICH. L. REV. 1009 (1944); W. Kopta, *What Constitutes the Unauthorized Practice of Law by Accountants in Tax Matters*, THE ACCOUNTING REV. (Jan. 1950).

of law or the practice of accounting, it should be frankly admitted that the preparation of a tax return *is* the practice of law, and in most cases it also *is* the practice of accounting. Inasmuch as it requires so much knowledge of both professions, it does not appear to be in the public interest to make the preparation of a tax return the exclusive, monopolistic function of either profession. Rather, it *is* in the general interest to hold every person who prepares a tax return to this single-standard of liability for which we are contending. Then an attorney would be held to the same standard of professional skill and care in a proper situation as a certified public accountant; a certified public accountant's handling of a tax return would be judged by the same standard of professional excellence as an attorney's in similar circumstances; and a layman would be held to the same standard as any other tax adviser.

Development of the thesis of a single-standard of liability in the preparation of a tax return can not be completed without a consideration of an extremely important corollary:

An adviser has the obligation to advise his client of the improper preparation of a prior tax return.

Whenever a taxpayer consults an adviser about the preparation of a new return it is the ordinary practice to begin with an inspection of the prior return as the best source of information regarding any unusual conditions affecting the current computations, such as capital losses, net operating loss carry-over, inventory, depreciation, and the like, as well as for the purpose of making a generally harmonious "tie-in" between the two years. If this inspection discloses errors on the previous return, the adviser is placed in the dilemma either of having to expose the errors and inevitably his predecessor, or of becoming a party to the injury of his client. If the error is one which can be corrected in such a way as to obtain a refund of the overpayment of tax and thus repair the damage to the client, can it be doubted that the adviser should disclose the possibility? Should there be any more doubt, then, if the damage can only be mitigated by recourse to the adviser who erroneously prepared the return? In fact, by assuming the peculiarly personal relationship of adviser-client necessary to a full inquiry into the client's private affairs for the purpose of making an accurate, true, and complete return, the adviser is shouldered with a fiduciary responsibility for a full disclosure of all the client's legal claims or, perhaps, assume the liability for them himself. If the client has a cause of action against a prior adviser which is not disclosed by his present one, and it later appears that the client has lost his right of action, perhaps by the running of the statute of limitations, may not the client hold the adviser liable for a breach of duty to advise him of his right?

The civil liability with which we have been primarily concerned has been that of the adviser to his client. But there is another aspect which should not

be ignored. Liability to the government for the correct amount of tax rests, of course, with the taxpayer regardless of whether his tax return may have been improperly prepared either with or without his knowledge or consent. But, suppose an additional amount of tax is subsequently assessed because of the correction of an erroneously prepared return, and suppose further, that the taxpayer is not now in a position to pay. May not the additional tax be collected from the adviser whose error resulted in damage to the government through loss of revenue?

Advisers have tried various devices in their efforts to avoid liability for the preparation of tax returns, none of which is successful. Some fail to sign the return as the one having assisted in its preparation, but it is a question of fact as to the participation by the adviser. Various formulas have been devised and stamped on the return, such as, "Prepared From Information Submitted By The Taxpayer," but again nothing is potent enough to accomplish freedom from liability within the scope of the adviser's employment. These devices are used primarily in an effort to escape any liability to the government, and, of course, are certainly ineffective in limiting liability to the client.

Liability insurance is a passive precaution available through some insurance companies to properly qualified persons. A typical policy agrees:

To insure the insured against direct pecuniary loss and expense arising from any claim . . . for damages caused or alleged to have been caused by the insured . . . in the performance of services rendered for others *in his professional capacity as accountant* . . . through neglect, error or omission, . . . (emphasis added) ⁸.

Under the laws of the State of Florida which define the practice of accounting ⁹ so inclusively and prohibit its practice by any one who does not hold a license from the State Board of Accountancy, it is very questionable whether any but a certified public accountant may lawfully render services for others *in his professional capacity as accountant* in that State.

It perhaps is unnecessary to summarize the conclusions of so brief an article, but it ought to be re-emphasized that there should be no double or triple standard of duty, care, or liability in the preparation of a tax return. The client, without any knowledge of the tax law, must rely absolutely upon his adviser. He may never know at what unnecessary cost the relationship was maintained because the over-payments of tax are rarely discovered. Only by being assured that his adviser is to be held to the same standard of performance as any adequately trained and fully qualified tax practitioner, can he be reasonably sure that his return will be prepared to his best possible advantage.

8. From a specimen policy of the New York Casualty Company.

9. FLA. STAT. § 473.01 *et seq.* (1941).

This, then, is an appeal to the legal profession to give more publicity to the single-standard concept of liability of those who prepare tax returns. It definitely is in the public interest to promote a wider, more general knowledge of the nature and extent of a client's rights against those who erroneously prepare his returns to his detriment. This broader public awareness of the responsibility for "malpractice" on a tax return would possibly almost obviate the disputes over what constitutes the unauthorized practice of law in the field of taxation.