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ACCOUNTANT'S
LIABILITY
NEWSLETTER

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AICPA Professional Liability Insurance Plan — Number 20 • December 1989

Evaluating Insurance Needs

By Arthur I. Cohn, Managing Partner
Goldenberg/Rosenthal, Philadelphia, Pennsylvania

Prior to 1984, certified public accountants engaged in public practice were rarely sued, and the cost of professional liability insurance was cheap. Most accountants paid little attention to this small overhead item, and we also had little contact with our insurance carriers. Our main objective was the performance of our professional services in a competent manner. That was history, and the real world is now and has been since 1984.

For the past five years, local practitioners have been practicing in a new environment. This new environment has been created by the number and severity of lawsuits brought against them, and the expansion of our liability by the courts. Our main goal is still to provide professional services in the most competent manner; but we are also now looking over our shoulders for that next lawsuit, and that once small overhead item has taken on greater significance.

Businesses adapt to the new and ever-changing business environment, and successful public accountants must do the same. We have changed our methods of performing our services, increasing our review process, providing more training for our staff, revising our professional standards, and instituting peer and quality review programs. Hopefully, in the long run, these practices will have a significant impact on the number and severity of lawsuits currently being experienced by the profession.

The jury may still be out as to whether as prudent businessmen we have approached the evaluation of our insurance coverage appropriately, including the choice of carrier, the quality of coverage, and the cost of obtaining this coverage.

We are all small and medium-sized firms. We market our services on the basis of the quality of service; our stability; our attentiveness to client needs; and lastly, cost. However, too many of us do the reverse when buying professional liability insurance. We put cost first. Cost is an important consideration, but not one if there is little or no insurance to buy.

As a member of the PLIP Committee, I have had an opportunity to discuss this issue with a number of practitioners; and as Managing Partner of my firm, I have paid considerable attention to this process. I would like to suggest that each of you when evaluating your insurance needs consider the following:

• Quality — Be sure to examine the policy language carefully to determine the type and scope of coverage. Are claims addressed promptly and by professionals skilled in accountant's liability matters?

• Stability — Is the insurance carrier committed to providing coverage? Has the company proven this commitment by continuing coverage during these most difficult years: Do you believe the company is going to provide coverage in future years? If not, who is?

• Attentiveness — Is there someone like me or other members of the PLIP Committee who have the same concerns and type of practice as me available to me? Is the broker and insurance carrier responsive in settling claims or, if necessary, the appointment of defense counsel?

• Cost — Is the cost of this year's premium reasonably competitive? The answer to this question has to be evaluated when considering each of the other criteria as well — quality, stability, attentiveness.

The AICPA Professional Liability Insurance Committee provides to each and every one of us that ombudsman with the insurance carrier and the broker. The members of the Committee are consumers like you, have the same concerns as you, and need the protection like you. The Committee is dedicated to achieving a product and service that satisfies

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the criteria by which each of us would like to be judged by our clients. The Committee members are dedicated to servicing us all; and you will probably not need to call on one of us for assistance, but isn't it nice to know that you can.

Tax Engagement Claims

Frequency and Severity Continue to Increase

By Mike Chovancak, Asst. Vice President, RBH
and Ken Mackunis, Underwriting Supervisor, RBH

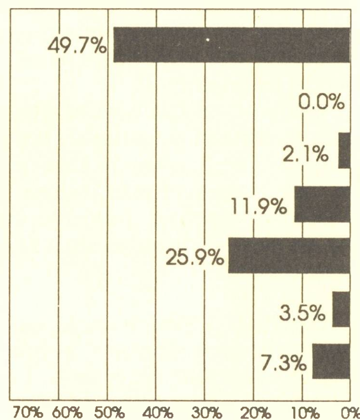
The passage of the Tax Reform Act of 1986 and the multitude of revisions of tax law has put additional pressure on the tax accountant to master these new laws. Unfortunately, it seems that the revisions have spawned a significant increase in tax-related claims under the AICPA Plan to the point where almost 50% of the number of claims involve tax engagements and the severity of claims has grown by an unbelievable 74.3% (see insert) compared to prior years.

Michael J. Chovancak, the Assistant Vice President/Underwriting Manager and Kenneth J. Mackunis, the Underwriting Supervisor of the AICPA Accountants Professional Liability Underwriting Unit have outlined loss prevention techniques that the accountant can use to avoid lawsuits, based on a review of current tax related losses.

- Mandatory use of engagement letters on all engagements.
- Careful selection of clients.
- Not suing for fees.
- Maintain high standards of quality control.
- Not accepting engagements for which your firm is not qualified.
- Keep current as to applicable accounting standards.
- DOCUMENT - DOCUMENT - DOCUMENT
- Establish a workable fee and payment schedule with each client prior to accepting the engagement.
- Use caution when making representations or advices, especially legal comments and/or opinions in writing.
- Maintain a balanced book of accounts, if an account comprises a majority of your billings, your independence of judgement may be distorted.

In a word, be prepared and don't take tax work lightly as if it carries little exposure for a lawsuit.

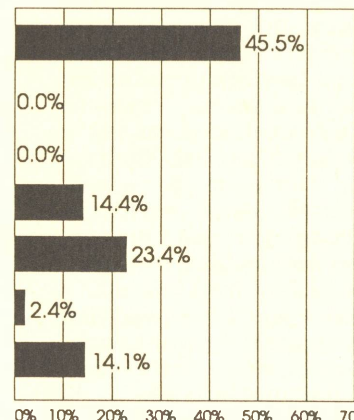
AICPA — New Loss Claims Activity — 1989



Incurred Claim Count
Note: The percentages above relate to a claim count of 286.

Categories

Tax Engagement
Insured Defalcation
SEC Securities
Audit Engagements
Accounting Services
Management Advisory
Business & Investment Advice



Incurred Loss by Distribution
Note: The percentages above relate to an incurred dollar distribution of $5,266,019.

The Reporting of Claims

By Dennis L. Bissett, Assistant Vice President
Crum & Forster Managers Corporation (Illinois)

In the last quarterly *Newsletter*, Carolyn Finch provided an answer to an often asked question, "When should I report a claim, or potential claim?" Ms. Finch, a Claims Unit Supervisor at DFM, provided timely and practical examples of situations that accountants encounter daily. Specifically, how to evaluate a situation and when to report the matter as a claim, or potential claim. The article and guidance it suggested was a success. Presently, CFM has received notices for over 50 separate claims, or potential claims, solely as a result of this article. This is a commendable result.

It may sound unusual for a claims person, one charged with the responsibility to operate the Claims Unit of the AICPA endorsed insurance program, to feel that 50 claims in addition to the normal reports of claims is commendable. That is, however, my personal assessment.

I have been working on the program for over three years. In

that period, over 1,500 notices of claims have been received by DFM. Still, claims experience suggests that more claims exist than are being reported.

But what is the concern, what difference does it make if a potential claim is reported now, or later? While there are many aspects to consider, the main issue is the matter of protecting your insurance coverage, and in effect, your firm and personal assets.

The professional liability coverage underwritten by CFM is a claims-made policy. In other words, coverage is triggered by the date the claim is received, not the date of the alleged error. Thus, if an engagement were completed in 1987 and no alleged error was reported until 1989, the 1989 policy would be triggered, not the policy at the time of the work. The importance of this is noted in the following actual example.

> Coverage is triggered by the date the claim is received, not the date of the alleged error.

Consider a small upper midwestern accounting firm. They had provided auditing services to a small financial institution for several years. The financial institution ultimately failed. As auditor, the accounting firm felt their work to be solid, capable of standing alone to scrutiny. They did not see a claim. The were, additionally, buoyed by the fact that the receiver solicited their input in assessing the damages, as well as in control of future activity.

The next year, the firm's insurance premium was slightly increased due to changes in the firm's business. The firm, after protracted internal discussion, decided not to renew their liability insurance. They were small, closely knit, they knew their clients, they had great pride in their work, and enjoyed an impeccable reputation in the community. They had never experienced a claim. Thus, from a financial standpoint, the benefit of insurance coverage was outweighed by the cost.

It was at this time that the attorneys for the FSLIC became involved. Asserting general negligence in the services to the client, FSLIC sent notice to the accountancy firm of an intent to file a claim. The insured responded in a timely manner, sending the FSLIC attorney's demand letter to CFM. Of course, a review of the claims-made policy indicated that coverage had expired. Notice of the claim, or potential claim, had not been received within the policy period. As can be imagined, it is not pleasant to call a former insured, an accountant that has built a solid personal and professional practice, and advise that there is no coverage for a potentially serious claim. While some limited advice on what they could do was offered, the fact remained that the accountant's practice was now in jeopardy. The feeling of despair was apparent in the partner's voice.

What could this practitioner have done differently? What would have provided protection of the firm, even though they felt very strongly that they had committed no malpractice. Very simply, they should have reported the potential claim upon first learning of the exposure. Had they done so, the insurance carrier would have had notice of the claim. In all likelihood, the insurance company would have contacted the insured, discussed the engagement, secured relevant papers and taken no further action. Then, if in one month, or five years, the FSLIC, shareholders, or other entity tried to assert a claim, the insured is protected up to the limit of liability. The company has record of the claim. It then makes no difference when, or if ever, a claim is formally asserted.

As an insurance professional, I can empathize with an insured's feeling that their work is commendable and that a given incident or series of facts as presented by a potential claimant is spurious. However, as shown from the situation related above, not reporting such questionable activities can result in financial disaster. The lesson from this is that, if you receive notice of a situation that could result in a claim, feel free to report and involve your insurer. Remember, no contact or activity will occur with the claimant, or potential claimant until the matter has been discussed fully with you. If no further activity is warranted, the matter will be held in abeyance. However, should later activity ensue, you will be protected.

> If you receive notice of a situation that could result in a claim, feel free to report and involve your insurer.

One further point. This article explains the benefit to the insured of prompt reporting of claims. But what value does the insurer receive from early notice of claims, or potential claims? This aspect will be discussed in the next edition of the *Newsletter*.

If you have questions, please feel free to contact me directly at (312) 993-6343.

Case Reviews

Tax: Illinois

Client's tax return information not confidential.

The Attorney General commenced a grand jury investigation of clients for alleged underpayment of retailers' occupation taxes and state income taxes spanning a 3-year period. Accountant who represented the clients was issued a subpoena *duces tecum* calling for the production of U.S. income tax records for the period under investigation, retained copies of state income tax records, all materials provided by clients used by accountant in preparation of any of

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the tax returns under investigation, and all work papers prepared by the accountant. The accountant appeared before the grand jury and answered questions posed by the prosecutor concerning his identity and whether he was served a subpoena; however, when asked questions of substance regarding his clients,

Information given an accountant to prepare a client's tax returns and the accountant's workpapers in preparing the returns thus are not confidential.

the accountant "respectfully declined" to answer further questions, citing privilege under Illinois law (§27 of the Illinois Public Accounting Act: "A public accountant shall not be required by any court to divulge information or evidence which has been obtained by him in his confidential capacity as a public accountant.") When the prosecutor moved to have the accountant held for contempt, the court declined to do so and the prosecutor appealed to the appellate level. The appellate court held the accountant was obligated to comply with subpoena because the information sought was not confidential. The accountant appeals to the Illinois Supreme Court.

Held: The Supreme Courts rules the accountant has no privilege. In so doing, the Court cites the four conditions necessary for the establishment of a privilege against disclosure of communications: 1) the communication must originate in a confidence that they will not be disclosed; 2) this element of confidentiality must be essential to the full and satisfactory maintenance of the relation between the parties; 3) the relation must be one which, in the opinion of the community, ought to be sedulously fostered; 4) the injury that would inure to the relationship by the disclosure of the communications must be greater than the benefit thereby gained for the correct disposal of litigation. See 8 J. Wigmore, Evidence §2285 at 527.

The Court then held that a tax client provides information to his accountant with the understanding that there may be, at the accountant's discretion and judgment, a disclosure of it to a third party, the state, or other parties, e.g., federal and other taxing authorities. It is understood that confidentiality is not to attach to the information. Information given an accountant to prepare a client's tax returns and the accountant's workpapers in preparing the returns thus are not confidential. As the information and papers cannot be considered as obtained by the accountant in his confidential capacity, they are outside the scope of the privilege.

Dissent: The dissenting opinion holds that the breadth of the statutory privilege indicates it was not only intended to encourage full and honest disclosure by the client but also nondisclosure of the client's confidences by the accountant (See 1 AICPA Professional Standards (CCH) at 52, 1984; AICPA Code of Professional Ethics). In absence of clear statutory language which excepts tax information from the privilege, the dissent believes the court cannot write such language in. *Ed. note: it is clear from the tenor of the decision, the majority was swayed by the long-standing rule on privilege whereby a client volunteers information in the presence of a third party or gives information which he knows that a professional is bound to disclose, the privilege is waived. It is questionable however, whether this rule should apply to all information given which relates to the non-privileged, or, more pertinently, whether it should also apply to all the the documents which in some way contain such information or a portion thereof.*

In re Grand Jury No. 746, Docket No. 65221, Illinois, 11/20/88.

Audit: Minnesota

Engagement letter limits accountant's liability.

An insurance company, the issuer of a commercial fidelity bond, issued such a bond to a health and welfare fund. On behalf of the insurance company, the fund's insurance agent requested a copy of the fund's audited financial statement, which had been prepared by an accountant who had prepared the audit previous to but not in expectation of the bond's issuance. The fund collected on the bond when it discovered that one of its employees had made false payments to herself in the amount of $104,413. The employee, a bookkeeper who processed and paid claims submitted by beneficiaries of the fund, was the only signatory required on checks for an amount less than $1,000.

After indemnifying the fund for its losses, the insurance company obtained an assignment of any claims the fund may have had against either the employee or the accountant. The insurance company then filed a lawsuit against the accountant claiming that the accountant's failure to review the internal control system and failure to comply with generally accepted auditing standards was professionally negligent. The accountant argued that any reliance upon the financial statements by the insurance company was unforeseeable and that the language of the written agreement between the fund (who had assigned their claims against the accountant to the insurance company) and the

The Court held that the engagement letter written and secured by the accountant limited his liability as to defalcations.

accountant limited the accountant's liability as to defalcations. The trial court agreed with the accountant and dismissed the suit; the insurance company appealed.

Held: The Appellate Court affirmed the trial court's decision, holding for the accountant. In so doing, the Court held that the engagement letter written and secured by the accountant limited his liability as to defalcations. The salient portion of the agreement read: "It is not contemplated that we will make a detailed examination of all transactions, such as would be necessary to disclose any defalcation or irregularities which may have occurred." The Court interpreted this language to exclude the accountant, as a matter of law, from any duty to detect employee defalcations. The Court went on to hold that although an accountant, under some circumstances, may have a duty to a third

party for pecuniary loss caused by a negligent audit, the third party must have justifiably relied on the false information. See Bonhiver v. Graff, 248 N.W.2d 291 (1976). **Tri-State Insurance Co. of Minnesota v. Krogus, No. C6-88-912, MN Ct. of App., 10/11/88.**

Tax: Florida

Tax shelter advice.

Clients retained firm to serve as their tax advisors and to prepare tax returns for the years 1976-79. On 12/30/76 the firm recommended that clients invest in a limited partnership, which the clients did. The firm attributed various deductions from client's taxes to the losses sustained by the partnership. In 1981, client received a deficiency notice from the IRS challenging the deductions taken by the firm. Clients contacted the firm and were advised that a sound basis for challenging the deficiency letter existed. Client then filed a petition to redetermine the deficiency, and when the IRS denied their petition, filed suit in U.S. Tax Court. However, in 1983, clients entered into a stipulation with the Service for the entry of a tax court order. Clients commenced an accounting malpractice suit against the accounting firm in 1985. Claiming that the statute of limitations on the suit had already run, the accountants moved for and were granted a dismissal of the suit. Client appeals.

Held: The Court finds for client and reverses the dismissal. In so doing, the Court holds that a cause of action for professional negligence does not accrue until the client knows or should have known a cause of action exists. A cause of action for professional malpractice does not arise until the existence of redressable harm has been established. Diaz v. Piquette, 496 So.2d 239 (1986). In this case, the clients did not suffer redressable harm until the tax court entered final judgment against them. If the tax court had not upheld the deficiency, clients would not have had a cause of action against the accounting for for malpractice. Thus, waiting to file the suit against the firm until after the tax court made its final decision, did not operate to bar the suit against the accounting firm. **Lane v. Peat Marwick, No. 87-2232, FL Ct. of App., 3rd Dist., 4/4/89.**

> In this case, the clients did not suffer redressable harm until the tax court entered final judgment against them.

Accounting Services: Pennsylvania

IRS assesses accounting firm for employment taxes due from firm's client.

The facts, as found by the bankruptcy court, are as follows: A cooperative engaged in the production and marketing of milk hired an accounting firm to perform professional accounting services. The president of the cooperative ran the day-to-day operations, and the accounting firm handled all accounting and financial affairs including calculating payroll, distributing pay checks, paying monthly bills, signing checks with facsimile stamp, and preparing and filing all federal, state and local tax returns. Decisions as to special debts were jointly made by the accounting firm and the president.

For reasons not pertinent to the case, the cooperative began experiencing financial troubles. Subsequently, the IRS determined the cooperative was $50,000 overdue on federal withholding, FICA, and FUTA taxes. The cooperative then asked the accounting firm for advice and guidance; the accounting firm formed a group of investors which loaned $250,000 to the cooperative specifically earmarked for taxes due and to become due within one year. Later, on discovering the taxes still had not been paid, the cooperative fired the accounting firm. The cooperative then filed for reorganization under Chapter ll, listing the withholding taxes in its schedule of debts.

The IRS then assessed the accounting firm as a "person responsible" under 26 U.S.C. §6672 for collecting, accounting for, and paying over the cooperative's employment taxes: the assessments at that time totaled $85,368. As a result,the accounting firm then filed for Chapter ll reorganization.

The bankruptcy court issued an order holding that the accounting firm was a "responsible person" under 26 U.S.C. §6672 and therefore liable for the delinquent federal employment taxes incurred by the cooperative. The firm appealed arguing it was only responsible for detail work for the cooperative, and that the Board of Directors of the cooperative made all decisions regarding disbursements and financial affairs.

Held: The Court adopted the bankruptcy court's findings of fact, and affirmed the order holding the accounting firm liable for the delinquent federal employment taxes.

26 U.S.C.§6672 provides:
Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over.

Two issues arise in an analysis of liability under 26 U.S.C. §6672: l) is the assessed person a "person responsible"; and, if so, 2) did the responsible person willfully fail to collect the tax.

> The Court found the factual findings established that the accounting firm was a "responsible person" under §6672.

Citing George v. United States, 819 F.2d 1008 (11th Cir. 1987), the court noted: "We consider a number of factors in deciding whether debtor was a responsible person under §6672, including:

(l) the ability to sign checks;
(2) the identity of the individuals who signed the Company's tax returns;
(3) the identity of individuals

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who were in control of the Company's financial affairs;
(4) the identity of individuals who hired and fired employees;
(5) the identity of officers, directors, and shareholders;
(6) the individual's entrepreneurial stake in the company."

The bankruptcy court found that the accounting firm handled the internal accounting, payroll, billing and accounts payable, and prepared and filed all federal, state, and local tax returns. The tax returns were signed by the accounting firm using facsimile stamps which were in the full possession and control of the firm. The Court found the factual findings were supported by the evidence, and that they established that the accounting firm was a "responsible person" under §6672.

As to the second issue, the burden is on the taxpayer to show their failure to pay employee withholding taxes was not willful. See Thibodeau v. United States, 828 F.2d 1499 (11th Cir. 1987). The court, citing George v. United States, 819 F.2d 1008 (11th Cir. 1987) again, stated: "The willfulness requirement is met if we find: (1) the responsible person had knowledge of payments to creditors other than the government, or (2) the responsible person showed a reckless disregard of a known or obvious risk that the taxes would not be paid." The court then concluded that the facts found by the bankruptcy court established that the accounting firm willfully failed to collect and pay the employment taxes because it had knowledge of taxes due to the government, of payments being made to creditors other than the government, and of funds loaned by the group of investors specifically for the payment of the taxes due.

In re Quattrone Accountants, Inc., No. 88-2065, Dist. Crt., W. Dist. of Penn., 5/2/89.

Practice Management

Reporting Checklist for Malpractice Claims

Probably one of the greatest stresses in an accountant's career occurs when a client or former client makes a claim against the accountant. After the initial shock wears off, the accountant is still left with the question, "What do I do now?" There are several avenues of action available but when it gets down to reporting the incident or claim to the Plan, you want to be sure it's done properly to ensure you receive the maximum in available coverage. Below is a practice checklist to follow during the actual reporting process:

1. Always communicate with the Plan using your letterhead.

2. Any notice of claim or incident should identify:
   a) name of insured
   b) policy number
   c) effective policy period
   d) state in which the policy was issued

   For convenience, put these above the letter body, *i.e.*, "Re: ________"

3. In clear, concise, plain language, outline the circumstances you are reporting. In your narrative include what the error or omission is alleged to be and the injury which has or may result. In doing so include:
   a) names and titles of involved firm members (from accountants to clerks)
   b) names and addresses of the party(s) alleging injury
   c) names and addresses of any witnesses
   d) the amount in controversy or the relief demanded
   e) the date you first became aware of the potential claim or incident or received notice of it (if different)

   Include copies of any suit papers/process you've received or been served with and include the date you received them.

4. Once you've identified a reportable situation, don't delay: report it to the Plan immediately to avoid any questions of timely notice.

5. Address all correspondence to claim personnel; if possible include their internal routes (i.e., claim unit number, etc.) to expedite the process.

6. Carbon copy of the notice should be sent to the insurance agent, underwriter or managing general agent, if applicable.

7. Send all claim notices by certified or registered mail so they can be traced and their delivery assured.

Unpaid taxes: the "person responsible"

A review of the Pennsylvania case in this issue (In re Quattrone Accountants, Inc., at p. 5) will demonstrate that accountants need to be vigilant to their possible liability for a client's unpaid taxes as a "responsible person" under §6672 of the Internal Revenue Code. It should also be noted that the

applicable section of Code provides for assessment of the total amount of the unpaid tax in addition to other penalties provided by law. Any accountant so closely associated with a client that the accountant could be found to have had the power to see that the client's taxes are paid, to make decisions as to disbursement of client funds, or to decide which client creditors will be paid and when, may well be subject to an IRS assessment for the client's unpaid taxes.

As for accountants preparing tax returns for clients, some of the penalties that can be assessed under the Code in addition to a §6672 assessment include:

IRC §7701(a)(36) defines a tax return preparer as any person who prepares, for compensation (or employs others to), all or a substantial portion of any return. Excluded from this coverage under this definition are estate, gift, employment tax returns, time extensions, and declaration of estimated tax. Preparation includes the rendering of advice, if that advice relates to something which has already occurred and is directly relevant to the treatment or characterization of an item on a return.

IRC § 6694(a) assesses a penalty of $100 against the preparer if any part of an understatement of taxpayer's income tax liability is due to the negligence of the preparer. Negligence in this context, is the failure to do what a reasonable and ordinary prudent person would do under the circumstances. Marcello v. Commissioner, 380 F.2d 499 (5th Circuit, 1967). While preparers may rely in good faith on information received from their client (without independent verification), preparers may not disregard information known to them, and must make reasonable inquiry if the information supplied appears to be either incomplete or incorrect. Once the Service has determined that an understatement has occurred, it is the preparer's burden of proof to establish the absence of negligence or intentional disregard. However, under §6694 a penalty will not be imposed if 1) the provision is so complex, uncommon, or highly technical that a competent preparer might reasonably be unaware or mistaken as to its applicability; 2) the understatement is the result of an isolated error; or 3) the understatement is of a relatively immaterial amount.

§6694(b) assesses a $500 penalty against the preparer for a willful understatement of taxpayer liability. This willful understatement occurs if the preparer intentionally disregards the facts given him by the client or others acting for the client. The preparer may rely on information given him by the taxpayer, but only insofar as that information does not indicate that additional verification is required. Unlike §6694(a), however, the IRS has the burden of proof.

While there are other penalty sections dealing with aiding the preparation of false or fraudulent returns [§7206 (2)]; evasion [§7201]; conspiracy to commit offense or defraud [18 USCS§371]; the above outlines the sections dealing with most cases of negligence, omission or relatively benign conduct. Notwithstanding the relatively insignificant financial penalties of §6694, however, the big stick carried by the Service is its ability to initiate proceedings to suspend or disbar any, C.P.A., attorney, or enrolled agent for incompetency, disreputable conduct, refusal to comply with the rules and regulations of practice under Circular 230, or the knowing and willful intention to defraud, deceive, mislead or threaten any taxpayer. Clearly, then, the prospect of disciplinary proceedings under Circular 230 should be a far more onerous event to the accountant than a mere $100 or $500 fine.

Tax Return Deficiencies: When Does Malpractice Attach?

The number of cases addressing alleged accountant malpractice and later developing tax difficulties relative to statute of limitations is limited. In determining when an action accrues against an accountant whose client's tax return has been challenged by the IRS, there are two basic lines of cases. The first holds that the statute of limitations starts to run when the client first becomes aware that the IRS disagrees with his return. See Isaacson, Stopler & Co. v. Artisan's Savings Bank, 330 A.2d 130 (1974). The second follows the theory that the statute does not begin to run until the issuance of the statutory notice of deficiency (26 U.S.C. §6212 (1982) or a formal notice of deficiency issued by the Service at a later point in the deficiency procedure. See Feldman v. Granger, 257 A.2d 421 (1969).

If the IRS procedures regarding deficiencies are examined, it appears they support the policy of starting the running of the statute of limitations at the time of the statutory notice of deficiency, or in

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the alternative, at the equivalent time of taxpayer agreement with the IRS as to the deficiency. In most cases tieing the statute of limitations to the deficiency notice will effectively operate to extend the time period a client has to sue his accountant for alleged negligence in preparing the tax return.

To briefly illustrate this apparent policy preference, consider the procedure for examination of tax returns and assessment of deficiencies: Tax returns are selected for examination, with the examination generally performed by examiners in the district officers of the IRS (20 Fed. Proc., L. Ed., Internal Revenue §48:305 (1983). At the conclusion of this examination, the taxpayer is sent a report of the examiner's findings, indicating any proposed adjustments in the tax liability (Id. § 48:389). At this point in the procedure, the taxpayer has the opportunity to agree with the findings of the examiner (by signing Form 870) or, if he does not agree, the taxpayer is informed of his appeal rights. If he signs the agreement, he waives the required statutory notice of deficiency (90-day letter) pursuant to 26 U.S.C. §6212 (1982), and the corresponding prohibition on collection for 90 days under 26 U.S.C. §6213 (1982); moreover, the taxpayer is precluded from litigating the proposed deficiency in Tax Court. See J. Chommie, Federal Income Taxation §295 (2d ed. 1973).

If the taxpayer does not agree with the examiner's proposed findings, the findings will be reviewed in the district office, and the taxpayer will be sent a 30-day letter instructing him that he has 30 days to file a protest (20 Fed. Proc., §48:392). If the taxpayer fails to respond within the 30 days, a notice of deficiency is issued. If the taxpayer timely files a protest, he will be accorded an appeals office conference. The appeals office has a broader negotiation and settlement authority than does the district office; if a settlement is reached the taxpayer is again requested to sign an agreement Form 870. A determination by the appeals office, however, is final insofar as the taxpayer's appeal rights within the IRS, and if the taxpayer continues to disagree, the statutory notice of deficiency will be sent giving him 90 days to file a petition in the Tax Court before collection actions begin (Id. at §48:440/460).

It is clear then that the preliminary findings of the examiner are only proposed findings, subject to review and negotiation prior to any determination of a deficiency, unless the taxpayer agrees with the findings or fails to pursue the internal review provided by the IRS. At any point in this procedure, an agreement by the taxpayer with the proposed adjustment results in a binding determination of tax liability upon which enforcement actions may be immediately commenced and precludes the necessity for the statutory notice of deficiency.

Given the provisional nature of the deficiency proposal by examiners in this procedure, it seems the Service has created a structure and policy ensuring that a taxpayer would not know or have reason to know that he has a cause of action against his accountant until such time as the notice of deficiency issues, or in the alternative, when the taxpayer has indicated his agreement with the position taken by the IRS. The key ingredient to a statute of limitations issue often turns on when the client knew or had reason to know the existence of the cause of action; this is the so called "discovery rule".

Taken as whole then, IRS procedures appear to favor supporting a policy of keying the statute of limitations to run against an accountant in a malpractice case at the time of the statutory notice of deficiency or, at the equivalent time of taxpayer agreement with the IRS' position — in either event, substantially after the act of any alleged accountancy malpractice; a more traditional approach would fix the date for the statute of limitations more closely to the alleged malpractice event. The net effect is that courts which follow the IRS favored application of the statute of limitations relative to deficiency-related malpractice actions will be acting to establish longer periods of time in which clients may file an accountancy malpractice action against their accountant in deficiency cases.

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