September, 2007

Tax Malpractice Damages: A Comprehensive Review of the Elements and the Issues

Jacob L. Todres

Tax Malpractice Damages:
A Comprehensive Review of
the Elements and the Issues

by

Jacob L. Todres*

* Professor of Law, St. John's University School of Law. The author would like to acknowledge the very able research assistance of Allan Wiesel, class of '08, and Michael Shapiro, class of '08.

Table of Contents

I. Introductory

The purpose of this article is to explore the proper measure of damages in tax malpractice litigation. Assuming a plaintiff establishes negligence by a tax advisor and the other requisite elements of the cause of action, exactly what damages may be recovered. May the plaintiff recover additional taxes owed? What about interest, penalties, lawyer's or accountant's fees? What about consequential damages such as emotional distress or mental anguish? What if as a result of the tax advisor's negligence the plaintiff is audited and other unrelated deficiencies uncovered that likely never would have come to light but for the initial negligence?

At a very simplistic level one would expect the contours of recoverable damages to be very well established by now. After all, a suit against a negligent tax advisor is likely to be either a relatively simple tort or breach of contract claim. Tort and contract law have been around forever. In any event, in more recent times as society has become more litigious,[1] and such cases have become more common,[2] the law should have had ample opportunity to develop definitive answers.

[1] See generally 1 RONALD E. MALLEN & JEFFREY M. SMITH, LEGAL MALPRACTICE ch.1 (2006 ed.); Michael P. Ambrosio & Denis F. McLaughlin, *The Use of Expert Witnesses in Establishing Liability in Legal Malpractice Cases,* 61 TEMPLE L. REV. 1351, 1352 (1988); Marc S. Galanter, *Reading the Landscape of Disputes: What We Know and Don't Know (and Think We Know) about Our Allegedly Contentious and Litigious Society, 31* UCLA L. Rev . 4, 5 (1983). See also, Republican Contract with America, "The Common Sense Legal Reform Act: Preface to Bill p. 1," http:// house.gov/house/contract/CONTRACT.html

[2] *See generally* Jacob L. Todres, *Malpractice and the Tax Practitioner: An Analysis of the Areas in Which Malpractice Occurs,* 48 Emory L. J. 547 (1999) ("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) ("Malpractice II").

In fact, while the basic elements and concepts concerning the proper measure of damages do seem to have been individually developed, a comprehensive overview of the area is difficult to glean. Also, many uncertainties and gaps in the law seem to remain. For instance, three views have developed as to whether interest incurred on a tax underpayment is recoverable as damages.[3] Likewise, there does not seem to be any authority on whether recovery is available when, due to a tax advisor's negligence, an audit is triggered and other, unrelated deficiencies uncovered.[4]

Finally, I have observed a relatively recent instance in which a federal court has either misstated or vastly oversimplified a basic principle in this area.[5]

The issue of the correct measure of damage is especially significant today in light of the crackdown during the past few years by both the IRS and Congress[6] on the abusive tax shelters of the 1990's and early 2000's. In addition to several publicized settlements by attorney and accountant defendants in a number of high profile class actions[7] and even criminal cases[8] that already resulted, many more suits against the tax advisors involved in

---

[3] *See infra* Part III. A.2

[4] *See infra* Part IV. A.

[5] Loftin v, KPMG LLP, 2002 U. S. Dist. LEXIS 26909 at *24 (S.D. Fla. 2002)(suggesting back taxes and interest are not recoverable damages)

[6] *See e.g.* Kenneth A. Gary, "More Shelter Settlements, Requests For Workpapers To Come, IRS Official Warns" *Tax Notes,* June 21, 2004, p. 1453; Kenneth A. Gary, "Year In Review: Tax Shelter Crackdown Efforts Steer Government Policy." *Tax Notes,* Jan. 5, 2004, p. 35; Sheryl Stratton, "News Analysis: Inside OTSA: A Bird's-Eye View of Shelter Central at the IRS," *Tax Notes,* Sept. 8, 2003, p. 1246. Congress acted in the American Jobs Creation Act of 2004, P. L. 108-357, 118 Stat. 1418. See §§ 811-22.

[7] *See e.g.*, Denney v. Jenkens & Gilchrist, 2005 U.S. Dist. LEXIS 2408 (S.D.N.Y. 2/18/05) (approval of $81.56 million settlement by attorneys); Simon v. KPMG LLP, D.N.J. No. 05-CV-03189 DMC, *stipulation amending settlement* filed 3/21/06 ($225 million settlement by KPMG and Sidley Austin Brown Wood).

such investments may be expected in the future. All this, in addition to the "normal" flow of such litigation.

In this article I hope to explore the damage area in detail. In addition to exploring the basic elements of recoverable versus non-recoverable damages, I hope to highlight a number of lurking issues, including some that have no clear-cut answers, and to offer suggested solutions for these.

I will focus on damages caused by attorneys and accountants interchangeably. While there might be some theoretical benefit in attempting to analyze these professions separately, the pragmatic truth is that the dividing line between the professions with respect to tax work has never been clear.[9] That dividing line, as faint as it always was, may have eroded still more in 1998 when Congress extended the traditional attorney-client privilege to other tax practitioners.[10] There are many instances in which attorneys and accountants share the defendant's role.[11] In many, if not most situations (except, perhaps, for purely litigation-related errors in a court other than tax court), the defendant could just as easily be from one

---

[8] United States v. Stein, No. S1: 05 Crim 0888 (LAK) (S.D.N.Y. 2005) (criminal case against KPMG personnel). *See also* Sam Young, *Ernst & Young Partners Indicted For Tax Fraud,* 115 Tax Notes 893 (6/4/07).

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

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

[11] *See e. g., Blair v. Ing,* 21 P.3d 452 (Haw. 2001); Estate of Smith v. Underwood, 487 S.E.2d 807 (N.C. 1997).

profession as from the other. In light of the interchangeability of the professions in tax practice, many courts simply hold both professions to the same malpractice standards.[12]

It should be noted in passing that occasionally the reported tax malpractice cases involve defendants other than attorneys or accountants. Such defendants typically are financial planners[13] or someone serving such function such as an insurance company or bank.[14] Similarly, a "non-professional" may serve as a tax return preparer.[15] While such cases may involve different standards concerning the duty of the defendant, where the court's discussion of damages is relevant, it will be included in the discussion.

Normally, civil actions for tax malpractice are usually based on either traditional tort or traditional contract theories.[16] 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.[17] In practice, these two standards, though emanating from different areas of the law, are virtually

---

[12] *See e.g. ,Hnath v. Vecchitto.* No. X03CV930502910, 2003 Conn. Super LEXIS 1063, at *22 (Conn. Sup. Ct. Feb. 20, 2003); Brown-Wilbert, Inc. v. Copeland Buhl & Co., P.L.L.P., 732 N.W. 2d 209, 218 n.4 (Minn. 2007). See also Malpractice I, *supra* note 2, at 551n. 13.

[13] *See e. g. Oddi v. Ayco Corp.,* 947 F.2d 257 (7th Cir. 1991). MCNC v. Aon, Consulting, Inc., 2006 WL 3733267, (M.D.N.C. 2006) (pension consultant).

[14] *See e.g., McKeown v. First Interstate Bank,* 240 Cal. Rptr. 127 (Cal App. 1987) (bank).

[15] *See e.g.,* Sorenson v. H&R Block, Inc., No. 99-10268-DPW, 2002 U.S. Dist. LEXIS 18689 (D. Mass. Aug 27, 2002), *aff'd*., No. 03-2268, 2004 U.S. App. LEXIS 17723 (1st. Cir. 2004).

[16] BERNARD WOLFMAN ET AL., STANDARDS OF TAX PRACTICE § 601.1 (6th ed. 2004).
The next few paragraphs in the text are adapted from Malpractice I and Malpractice II *supra* note 2.

[17] *Id.*

identical. The professional, therefore, must exercise reasonable competence and diligence to avoid malpractice exposure.[18]

While the basic standard of care is almost identical under tort and contract theories, other aspects of the causes of action and/or defenses thereto may differ depending on which theory is utilized. Differences are usually encountered in the statute of limitations (both how long and when it commences), the measure of damages, to whom liability extends (i.e. privity), and evidentiary matters, such as the need for expert testimony.[19] Several recent cases underscore that differences remain between the two theories and the need to carefully comply with the requirements of each theory.[20]

Usually, the malpractice tort asserted against an attorney is a specific application of the ordinary tort of negligence. The attorney must act as a reasonably competent and careful professional would act under similar circumstances.[21] Since tax law generally is perceived as a specialty, the standard of care may be higher than in other attorney malpractice situations.[22] To establish a *prima facia* cause of action, a plaintiff must show "(1) a duty owed by the

---

[18] *Id.*

[19] *Id* at 460.

[20] In Sorenson v. H&R Block, Inc., *supra* note 15, the court denied any recovery under a number of different tort theories while permitting recovery under a contract theory. *Id.* at *19-42. In Tony Smith Trucking v. Woods and Woods, Ltd., 55 S.W. 3d 327 (Ark. Ct. App. 2001), the plaintiffs attempted to qualify for the longer five-year contract statute of limitations instead of the three-year tort statute by arguing that a contract was formed when their accountant signed the power of attorney form to represent them at the IRS audit. The court rejected this argument and held a contract exists only if a specific promise or undertaking is present. If the allegation is simply of a breach of the general duty to act diligently, the claim is for negligence, not for breach of contract. *Id.* at 331.

[21] WOLFMAN ET AL., *supra* note 16, § 601.2.1.

[22] *See id*. § 603.3; *see also* 3 MALLEN & SMITH, § 23.26, *supra* note 1; Malpractice I, *supra* note 2, at 553-54.

attorney to the plaintiff …; (2) breach of that duty …; (3) injuries suffered by the plaintiff; and (4) a proximate cause between the injury suffered and the attorney's breach of duty."[23]

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 facia* cause of action against the accountant are the same as those listed above against an attorney.[24] Many cases simply equate the elements of the causes of action and the standard of care in accountant and attorney situations.[25]

While the normal tax malpractice cause of action involves the tort of negligence, other torts are also encountered. In one case,[26] in addition to negligence and breach of contract claims, there were also 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

---

[23] WOLFMAN ET AL., *supra* note 16, § 601.2.1 (citation 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., 182 F. Supp. 2d 637, 638 (N.D. Ohio 2002) (listing the elements as duty, breach and injury or damages); Boardman v. Stark, No. 20911, 2002 Ohio App. LEXIS 3790, at *4-5 (Ohio Ct. App. July 24, 2002) (duty, breach and causal connection between the conduct and damages); Jones v. Bresset, 47 Pa. D. & C. 4th 60, 70 (Pa. Ct. Com. Pl. 2000) (listing, duty, breach and proximate cause). Similarly, in other contexts, a fifth element (causation in fact) is added. *See, e.g.*, DAN B. DOBBS, THE LAW OF TORTS § 114 (2001).

[24] WOLFMAN ET AL., *supra* note 16, § 601.2.2

[25] *See* Malpractice I, *supra* note 2, at 551 n.13; *see also* Hnath v. Vecchitto, No. X03CV930502910, 2003 Conn. Super. LEXIS 1063, at *22 (Conn. Sup. Ct. Feb. 20, 2003) (adopting same accrual of cause of action date for accountant as for attorney).

[26] Sorenson v. H&R Block, Inc., *supra* note 15.

deceptive trade practices under state law.[27] Allegations of fraud,[28] violations of federal securities laws[29] and RICO violations[30] may also arise in tax malpractice situations.

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 involved. This article will not focus upon any other state or federal statutory basis for recovery.

II. Damages – General Background

The role of damages in our tort law is to compensate the victim of negligence for her or his injuries. In tax malpractice, as in other types of professional malpractice and as in other areas of negligence law, generally, the plaintiff is entitled to recover for all injuries proximately caused by the defendant's negligence.[31] In general, the damages are the difference between the position the plaintiff would have been in with nonnegligent performance by the defendant and the plaintiff's current position. Stated somewhat differently, the plaintiff is entitled to recover for the loss of any expected benefit that competent performance would have yielded.[32]

---

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

[28] *See e.g.,* Baker v. Bennett, 603 So. 2d 928 (Ala. 1992); Alpert v. Shea Gould Climenko & Casey, 559 N.Y.S. 2d 312 (1st Dep't. 1990).

[29] WOLFMAN ET AL., *supra* note 16, § 605.2.3; Malpractice I, *supra* note 2, at 634.

[30] 3 MALLEN & SMITH, *supra* note 1, § 23.26.

[31] Wolfman, *supra* note 16, at § 605.1.1; 3 Mallen & Smith, *supra* note 1, at 3.

[32] *Id.*

This basic measure of damages is the same regardless of the context of the tax malpractice. It seems that there are three broad areas in which tax representation, and consequently malpractice, may arise: tax planning, tax return preparation, and subsequent representation. Tax planning occurs before a transaction occurs. It involves professional advice as to how to structure a transaction or how to plan gifts or an estate. Return preparation has the obvious meaning relating to the process of reporting to the appropriate authorities (federal, state and, perhaps, foreign) a transaction or events that already occurred. Subsequent representation would refer to all post-return filing services such as representation during an audit, at administrative hearings, in response to administrative communications or in litigation.[33]

Damages that may be recovered are only for those injuries that have actually occurred. No recovery is permissible for injuries that may occur at some future point in time, *i.e.*, for speculative damages.[34] It should be noted that difficulty in calculating damages has no bearing on the issue of whether damages are speculative. Rather, the basic issue is whether there are any damages or not.[35]

---

[33] Filing an amended tax return, at first, may not seem to fit easily within the suggested three part division of tax services. However, it is suggested that it is either part of the return filing process, as where some error or omission on the original return came to light and it is subsequently corrected by the original return preparer or by another. Alternatively, if the amendment is prompted by a new, (perhaps even the old) advisor's later review of the facts or tax return and results from a decision to take a different position, then it seems to fit under subsequent representation.

[34] WOLFMAN ET AL *supra* note 16 at § 605.1.1 3 MALLEN & SMITH, *supra* note 1, § 20.3 at 9. See the discussion *infra* at Part III.B.

[35] 3 MALLEN & SMITH, *supra* note 1, § 20.3 at 9-10.

Damages are usually divided into two categories: direct and consequential. "Direct damages are those damages that are immediate, natural and anticipated consequences of the wrong. Consequential damages are compensation for those injuries that flow, because of the direct damages and, therefore, depend on special circumstances that are not necessarily anticipated." (footnotes omitted)[36] "In other words, consequential damages, although the proximate result of the defendant's negligence, do not represent the loss of an anticipated benefit, but rather *result from the loss of such benefit"* (emphasis in original).[37] Although I will also continue to use the direct versus consequential damages terminology since it is so entrenched in tort law, it seems to me that the real issue is forseeability and proximate causation. At some point, though flowing from the negligence, the damages may be so remote as to not have been foreseeable and, hence, not recoverable. This result may also be obtained by treating such remote damages as not proximately caused by the defendant's negligence, or, perhaps, as being speculative.

One other aspect of recoverable damages needs to be focused upon and that is the general requirement imposed upon an injured party to mitigate damages. Under normal tort principles, damages that may be minimized or reduced through reasonable efforts are not recoverable.[38] In the tax context this would be illustrated if, for instance, a return preparer makes a simple mechanical error such as reporting $10,000 of income as $100,000 or neglecting to claim a valid deduction. The recoverable damages would normally not include

---

[36] *Id*. at § 20.1 at p. 3.

[37] WOLFMAN, *supra* note 16, § 605.1.2. at p. 503.

[38] 3 MALLEN & SMITH, *supra* note 1, § 20.10 at 28-29.

the full amount of the additional tax since an amended return easily could be filed to correct the error so long as the statute of limitations is still open. As a concomitant to not being able to recover the avoidable additional tax, the plaintiff may recover his or her mitigation expenditures; here, the cost of filing the amended return.[39] Such mitigation or corrective costs, whether or not ultimately successful, are ordinarily an important element of recoverable tax malpractice damages.

III. Elements of Damages

A. Direct or Core Damages

In tax malpractice situations, the most direct types of damages encountered consist of additional taxes resulting from the malpractice, interest and penalties imposed on the additional taxes, and corrective costs incurred to attempt to eliminate or mitigate all or some of the foregoing damages. While not all of these damages are asserted in each and every tax malpractice case, and while many other types of damages are also encountered, these four types of damages seem to comprise the basic group of direct damages most frequently encountered. This group will be referred to herein as "core damages."

Since the determination of recoverable damages is a matter of state law, differences among the states would be expected, and, in fact, exist. Thus, while there seems to be general agreement that penalties and corrective costs are recoverable, the situation concerning taxes and interest is different. As to taxes, though the language encountered would seem to suggest a more fundamental disagreement, it appears that most states allow

---

[39] *Id.*

recovery of the additional taxes caused by the malpractice. What is not recoverable is other taxes incurred by the plaintiff, *i.e.*, taxes that would have been incurred even in the absence of the malpractice. With respect to the interest imposed on a tax underpayment, three distinct approaches are evident: one approach permits the recovery of such interest from the defendant, one approach denies any recovery of such interest and a third approach stands in-between these two extremes and permits recovery of some interest, but only to the extent the interest paid by the plaintiff to the government exceeds the interest earned by the plaintiff on the tax underpayment.

1. Additional Taxes

The general rule in this area seems well settled that recovery is available for additional taxes that were avoidable but for the negligence, but not for other, unavoidable taxes.[40]

> Although necessary taxes may not constitute an injury to a client's interests, taxes which could have been avoided by the exercise of the knowledge, skill and ability ordinarily possessed and exercised by legal professionals under similar circumstances can be considered as an injury[41]

---

[40] *See* e.g., O'Bryan v. Ashland, 717 N.W.2d 632 (S.D. 2006). Sims v. Hall, 592 S.E.2d 315 (S.C. App. 2003); J.D. Warehouse v. Lutz and Co., 639 N.W. 2d 88 (Neb. 2002); Pytka v. Gadsby Hannah, LL.P. 15 Mass. L. Rep. 451, 2002 Mass. Super. LEXIS 461 (2002): King v. Neal, 19 P.3d 899 (Okla.Civ. App. 2001). *But see* Carroll v. LeBoeuf, Lamb. Green and MacRae, LL.P., 392 F.Supp.2d 621, 629 (S.D.N.Y. 2005) (noting that New Jersey courts have not addressed recoverability of taxes).

[41] Hosfelt v. Miller, 2000 Ohio App. LEXIS 5506 at *14.

> The…[plaintiffs] were, and are, under a legal duty to pay taxes… We note that if the malpractice action ripens, the appropriate measure of damages is the difference between what the … [plaintiffs] would have owed in any event if the tax returns were properly prepared, and what they owe now because of their accountants' negligence, plus incidental damages. The …[plaintiffs] should not recover as damages all taxes owed…[42]

Recovery of additional taxes has been awarded in many different situations. For example, in *Cameron v. Montgomery*[43] the attorney for an estate filed the estate tax return late thereby preventing the estate from utilizing the alternate valuation date. Included among the damages awarded was the extra taxes incurred.[44] In *Jerry Clark Equipment, Inc. v. Hibbits*[45] the defendant accountant, who was also an attorney, failed to file the plaintiff's tax return as agreed. The damages awarded included the extra taxes incurred by the plaintiff that could have been avoided with minimal tax advice from the defendant.[46] In *King v. Neal*[47]extra taxes were awarded as damages where the defendant tax attorney/return preparer

---

[42] Thomas v. Cleary, 768 P2d 1090, 1092 n. 5 (Alaska 1989). *See also* O'Bryan v. Ashland, *supra n.* 40, 717 N.W.2d at 633. ("In ordinary circumstances…the taxpayer cannot recover as damages the tax deficiency itself because the tax liability arose not from the negligent advice, but from the ongoing obligation to pay the tax.")

[43] 225 N.W.2d 154 (Ia. 1975)

[44] *Id*. at 155. In re Estate of Lohm, 269 A.2d 451 (Pa. 1970) involved a similar dereliction, but here the dereliction was compensated by reducing the fees awarded the executor and the estate's attorney.

[45] 612 N.E. 2d 858 (1993).

[46] *Id.* at 861

advised that certain deductions be taken in a later year and it was too late to file amended returns for the earlier years when the error was discovered.[48]

Similarly, the additional taxes caused were awarded as damages where: (1) attorneys failed to advise of the existence of the disclaimer for estate tax purposes;[49] (2) an "attorney" failed to obtain long term capital gain treatment that was obtainable with better planning;[50] (3) an S corporation election form was not filed thereby causing the plaintiff to incur corporate level taxation;[51] and (4) erroneous advice resulted in the plaintiff receiving taxable rather than tax free disability benefits.[52] Also, similar results occurred in several tax shelter situations, both where the tax advisor recommended faulty tax shelters[53] and even where the tax advisor failed to find a tax shelter after having promised to do.[54]

---

[47] 19 P.3d 899 (Okla. 2001)

[48] *Id.* at 900-01.

[49] *See e.g.,*Sims v. Hall, 592 S.E. 2d 315 (S.C. 2003); Hosfelt v. Miller, 2000 Ohio App. LEXIS 5506 (Ohio Ct. App. 2000).
If a person who is to inherit property wishes to reject the inheritance, rejection by any means other than a qualified disclaimer will result in the person being treated as if she or he accepted the inheritance and then made a transfer subject to gift tax. *See generally* RICHARD B. STEPHENS ET. AL., FEDERAL ESTATE AND GIFT TAXATION §§ 10.01[2] [g], 10.07[1], (8th ed. 2002). A qualified disclaimer is defined at IRC § 2518(b), 26 U.S.C. §2518 (b).

[50] Pytka v. Gadsby Hannah, LLP., 2002 Mass Super. LEXIS 461 (2002). Here the individual defendant was held out to be an attorney and of counsel at the defendant law firm. Although he turned out not to be an attorney, the court treated him as if he were an attorney. *Id.* at * 19

[51] Estate of Smith v. Underwood, 487 S.E. 2d 807 (N.C. Ct. App.1997)

[52] Jamison, Money, Farmer & Co. v. Standeffer, 678 S.2d 1061 (Ala. 1996)

[53] *See e.g*., Harrell v. Crystal, 611 N.E.2d 908, (Ohio App. 1992).

[54] Eckert Cold Storage v. Behl, 943 F. Supp. 1230 (E.d. Cal. 1996). It should be noted that *Eckert* involved a California Statute, Cal. Civ. C. § 333, but its measure of damages seems to be the same as the common law rule in many states: "the measure of damages …is the amount which will compensate for all the detriment caused" by a defendant's tortious conduct. *Id. at 1233*.

Though the rule appears to be that additional taxes caused by tax malpractice are recoverable, special note must be taken of the New York case of *Alpert v. Shea Gould Climenko and Casey,*[55] which holds to the contrary. In *Alpert* the plaintiffs invested in a tax shelter that later was determined to be invalid. They were seeking to recover back taxes, including tax benefits they could have obtained had they not invested in the present tax shelter that the defendant attorneys opined was valid, and instead invested in a viable tax shelter.[56] The court held that no back taxes may be recovered, and certainly not those tax savings obtainable from an alternative investment overlooked in favor of the fraudulent one.[57] While this is inconsistent with the general rule and all the cases noted that awarded additional back taxes as damages, *Alpert* is distinguishable. *Alpert* involves a cause of action for fraud, in which damages are essentially recessionary,[58] rather than for negligence, where benefit-of-the-bargain damages are recoverable.[59] Although this seems to be a compelling distinction, *Alpert* seems to be followed in New York[60] and remains problematic.

In analyzing *Alpert* it is important to note that it addresses two distinct issues. In addition to holding that back taxes may not be recovered as damages, it also holds that interest paid on a tax underpayment is not recoverable as damages in a tax malpractice action.[61] In fact, as will be discussed in the next section of this article, *Alpert* is one of the

---

[55] 559 N.Y.S.2d 312 (1st Dept. 1990)

[56] *Id.* at 314

[57] *Id.* at 314-15

[58] *Id.*

[59] See WOLFMAN ET AL., *supra* note 16 at §605.1.1

[60] See e.g. Gertler, M.D., P.C., v. Sol Masch & Co., __N.Y.S.2d __, 2007 N.Y. Slip. Op. 03967 (1st Dep't. 2007).

leading cases for the latter point of view.[62] While *Alpert* has found a following for its no-interest-recovery holding, there seems to be no justification, and no following outside New York, for its position that additional taxes caused by a defendant's negligence are not recoverable in tax malpractice situations.

a. Determining Additional Taxes

In focusing on the additional taxes recoverable as damages, initially one needs to keep in mind the very basic threshold requirement that only actual damages may be recovered; not those that are merely speculative. *Thomas v. Cleary*[63] is a good illustration of the problem. In *Thomas* the plaintiffs, the Clearys, employed the defendant accountant and his firm to render accounting and tax advice concerning the sale of their business in 1976 and the related liquidation of their corporation. The accountants were responsible for filing the required tax returns for 1976 and 1977.[64] In January 1978, eighteen months after the sale of the business, the plaintiffs received a letter from the defendants informing them that they owed an additional $100,000 in taxes. The plaintiffs then discovered that the defendants failed to file tax returns for 1976 and 1977. At trial, the jury awarded the plaintiff over $212,000 in damages, primarily for unpaid corporate taxes.[65] On appeal to the Alaska Supreme Court, in a three-to-two decision, the court reversed the judgment for the plaintiffs. The majority held that since the IRS had never sent plaintiffs a deficiency notice nor imposed

---

[61] *Alpert*, *supra*, 559 N.Y.S. 2d at 315.

[62] *See infra* Part III.A.2.

[63] 768 P. 2d 1090 (Alaska 1989)

[64] *Id.* at 1091.

[65] *Id.* at 1091-92.

any tax assessment, no damages were yet incurred and therefore no cause of action existed.[66] The majority held this way, despite acknowledging that the plaintiffs still had potential liability as transferees for the then eleven year old taxes because the statute of limitations never began to run since no tax return was filed.[67] The majority was not willing to rely on the expert testimony that had been introduced as to the damages caused by the defendant accountant, not just by virtue of failing to file the tax returns but also by incorrectly structuring the sale as an asset sale rather than a stock sale.[68]

While *Thomas* focused on the existence of an IRS assessment of the tax, or perhaps, on this in conjunction with the issuance by the IRS of a notice of deficiency[69] as the point at which extra tax damages become definite rather than speculative, other indicia are also possible. In *Bronstein v. Kalcheim and Kalcheim, Ltd.*,[70] the Illinois Appellate Court held that a plaintiff's damages remained speculative and uncertain until the Tax Court reached a final determination notwithstanding the fact that the IRS has previously issued a notice of deficiency.[71] The leading treatise on tax malpractice, immediately before discussing *Bronstein* simply states that with respect to negligent tax planning advice, a plaintiff

---

[66] *Id.* at 1093-1094.
[67] *Id.* at, 1093 n. 7.

[68] *Id.* at 1094-95 (dissent's discussion of the expert testimony).

[69] The *Thomas* majority opinion is not very clear as to precisely what takes the anticipated additional taxes out of the realm of speculation. At the beginning of its discussion the court refers to both the absence of a deficiency notice and the absence of any tax assessment. *Id.* at 1093. However, the court then seems to focus only on the absence of the IRS tax assessment. *Id.* at 1093-94.

[70] 414 N.E. 2d 96 (Ill. App. 1980).

[71] *Id.* at 98. In *Bronstein*, the plaintiff sued his attorney for negligently advising that a lump sum payment to his ex-spouse was deductible. The IRS disallowed the deduction and issued a notice of deficiency. The plaintiff subsequently challenged the deficiency in Tax Court. While the Tax Court case was pending, this malpractice action was brought against the attorney. The Illinois Appellate Court dismissed the suit as premature, since no damages could be suffered until the Tax Court reached a final determination. *Id.*

It is interesting to speculate whether the court would have held as it did if a Tax Court case was not already pending when the tax malpractice suit was instituted.

generally is not entitled to recover for taxes assessed by the IRS prior to a final administrative decision,[72] which, presumably, follows *Thomas*.

Contrary to *Thomas* and *Bronstein,*, in *Jameson, Money, Farmer & Co. v. Standeffer*,[73] the court had no problem relying on expert testimony to establish the amount of state taxes that would be incurred as a result of the incorrect advice rendered by the defendant accountant. The court specifically rejected the defendant's argument that relying on such evidence amounts to making an award of speculative damage.[74]

Apart from the general threshold requirement that damages be definite and not merely speculative, it is interesting that most cases do not focus on how to determine the extra taxes caused by the defendant's negligence. Presumably in many situations the determination will be relatively straight forward. For instance, in the return preparation context, it should be relatively simple to determine how much additional taxes are involved. Thus is *Cameron v. Montgomery*[75] the loss of the right to utilize the alternative valuation date for estate tax purposes because of the defendant's failure to file a timely tax return was easily quantifiable.[76] Similarly, though the court never explained its computation, in *Jerry Clark Equipment, Inc. v. Hibbits,*[77] the court was able to determine how much taxes could have been avoided had the defendant rendered some minimal level of tax planning advice.[78]

---

[72] WOLFMAN ET. AL., *supra* note 16 at § 605.2.2 at p. 508.

[73] 678 So. 2d 1061 (Ala. 1996).

[74] *Id.* at 1067

[75] 225 N.W. 2d 154 (Ia. 1975).

[76] Presumably the extra tax was simply the difference between the estate tax imposed using the date of death value minus the tax that would have been imposed using the alternate valuation date values.

[77] 612 N.E. 2d 858 (Ill. App. 1993).

Where the negligence arises in the context of a subsequent representation situation such as where a tax advisor was retained to represent a taxpayer in connection with a tax audit or to litigate the amount of tax due, the amount of additional taxes will need to be established by the normal trial within a trial procedure.[79] As part of the plaintiff's case the plaintiff will need to establish the result that would have obtained with non-negligent representation at the audit or litigation, which presumably will require the use of expert testimony.[80]

The most difficult type of cases in which to establish recoverable damages likely will be those involving negligent tax planning. A good example of the difficult intricacies involved in attempting to prove the extra taxes caused is presented in *Oddi v. Ayco Corp.*[81] In *Oddi* the defendant was an investment counseling firm which advised the plaintiff on how to take his early retirement distribution. The plaintiff wanted to take his total retirement funds, roll them over into an IRA and then take the minimum required distributions over his and his wife's lifetimes. Under this approach, no taxes would be incurred at retirement, the funds in the IRA would continue to grow tax-free and tax would be incurred only as the funds were withdrawn later from the IRA.[82] After several attempts, the defendant's counselor convinced the plaintiff to take instead a lump sum distribution of his retirement funds, incur immediate tax, though at favorable rates, and then invest the remaining funds for

---

[78] *Id.* at 861-62.

[79] 3 MALLEN & SMITH *supra* note 1, §20.3 at 11.

[80] *See e.g., Jameson, Money, Farmer & Co. v. Standeffer*, 678 So. 2d 1061 (Ala. 1996) (expert testimony established amount of anticipated state taxes).

[81] 947 F.2d 257 (7th Cir. 1991), *amended*, 1992 U.S. App. LEXIS 1014 (7th Cir. 1992).

[82] *Id.* at 259-60. A newly imposed excise tax on large retirement plan accumulations would likely also be incurred. *Id.*

retirement income. As part of her selling job to convince the plaintiff to take the lump sum distribution, the counselor showed the plaintiff a comparison of the alternative plans which showed that over the lifetimes of the plaintiff and his wife the lump sum plan was better than the rollover plan by approximately $3 million. Unfortunately, the counselor had made a very serious error in preparing the comparison, reversing the assumed rate of return on taxable and non-taxable investments. In fact, a correct calculation indicated that the rollover plan was approximately $2 million better than the lump sum plan.[83] The plaintiff then sued the defendant for the damages.

In order to calculate the additional taxes caused by the bad advice, it was necessary to select life expectancies for the plaintiff and his wife, a spread between taxable and tax-free investments, and an income tax rate over the plaintiff's and his wife's lifetimes, among other assumptions. At trial, the plaintiff was awarded the present value of damages sustained plus income tax on the award.[84] On appeal, the major issue raised by the defendant was that the trial court assumed that the then current, and historically very low, tax rate (28 percent) would remain in effect indefinitely, and did not place the burden of establishing this on the plaintiff. Any tax rate increase would reduce the plaintiff's damages, perhaps even to the point of disappearing entirely. In affirming the decision below the Seventh Circuit held that under Illinois law it was appropriate to presume the current tax rate would continue and that the burden of proving tax rates would change was properly placed upon the defendant.[85] The

---

[83] *Id.* at 260.

[84] *Id.* at 261.

[85] *Id.* at 261-62.

Seventh Circuit also affirmed the inclusion in the damages award of an amount for taxes to be incurred by the plaintiff on receipt of the basic damage award.[86]

The definition of additional taxes utilized by several courts in fixing damages in tax planning situations seems rather questionable. In *J.D. Warehouse v. Lutz and Co.*,[87] the owner of a warehouse sold the warehouse to a governmental agency that was redeveloping the area in which the warehouse was located. The sale occurred under threat of condemnation. As such, under IRC section 1033[88] it was possible to avoid immediate taxation of the gain recognized on the sale by reinvesting the entire sales proceeds into similar property. The plaintiffs, the general partnership owning the warehouse and its three general partners, inquired of the defendant accountant how to accomplish this. The accountant erroneously advised them that they needed to reinvest only their gain from the sale ($2.44 million) rather than the full sales proceeds ($3.15 million). The plaintiff therefore purchased replacement property costing only $2.5 million. The IRS subsequently caught the error on audit and adjusted the partnerships' tax return to reflect taxable capital gain of over $522,000. The plaintiffs then sued the accountant for the additional taxes, interest and other costs incurred.

The trial court, rather oddly, held that there were no additional taxes caused by the defendant's negligence so there could be no recovery of any taxes:[89]

---

[86] *Id.* at 267-68.

[87] 639 N.W. 2d 88 (Neb. 2002).

[88] 26 U.S.C. § 1033.

[89] 639 N.W. 2d at 91-92. The trial court also focused on the fact that gain avoidance under I.R.C. § 1033 really just deferred the tax rather than completely avoid it. This aspect of the holding is discussed *infra*, Part IV.B..

> In this case, the taxpayers realized their gain and their liability for the tax was incurred at the time that the Partnership sold the John Deere warehouse building. That was prior to the time the partners sought advice from the Defendants. The transaction, creating the taxpayer's liability preceded the Defendant's negligence and hence, the Defendants cannot be the legal cause of the Plaintiff's tax liability. Since the taxpayers were always ultimately responsible for the tax due on the gain, the erroneous tax advice in this case did not create the Plaintiff's tax liability.

With all due respect, the trial court seems to have completely missed the issue. Of course the basic tax had already been incurred. There always must be an antecedent gain before the issue of how to avoid immediate recognition of it under IRC section 1033 can arise.[90] The accountant here was retained to advise the plaintiffs on the requirements of section 1033 to avoid immediate taxation, and they rendered negligently incorrect advice. Any amount of tax presently incurred that could have been avoided should have been treated by the court as recoverable additional tax.

On appeal, the trial court's decision was affirmed, but on procedural grounds. The Nebraska Supreme Court held there was a failure of proof and therefore taxes could not be awarded as damages. It seems the stipulation of facts on which the case was tried only

[90] It seems unlikely that a different result would have occurred if the erroneous advice had been rendered prior to the sale of the warehouse rather than afterwards. Such timing is fortuitous and not related to the negligence and should not impact any recovery.

indicated the amount of gain added back by the IRS on the partnership's tax return, but never indicated the amount of additional taxes paid on this amount by the partners and the court would not speculate as to the amount of taxes involved.[91]

In several other tax planning cases involving "pie-in-the-sky" promises by tax professional the courts also seem to utilize a rather unusual measure of damages. The courts seem to be willing to award the difference between the plaintiff's taxes and the lowest taxes that could have been achieved with proper advice. However, the courts seem to totally ignore what the tax professional promised. For instance, in *Whitney v. Buttrick*,[92] the plaintiff was a seventy-five percent shareholder in a corporation and was contemplating selling his interest to the owner of the remaining twenty-five percent. Based on the defendant attorney's representation that he had tax experience and could structure the deal to accomplish a "no tax" sale, the plaintiff agreed to sell. Under the terms of sale, the plaintiff sold his shares for approximately $200,000 paid as follows: cash ($200), assets ($80,000) and a note ($129,000). The plaintiff also assumed approximately $11,000 of liabilities in connection with the sale.[93] It later turned out that the sale was not "no tax" and the IRS notified plaintiff that a tax liability of over $98,000 was incurred. The plaintiff then sued the attorney for malpractice. At the trial, before a jury, the judge erroneously utilized the Minnesota out-of-pocket damages rule for misrepresentation torts, under which a plaintiff may recover only the difference between what he gave and what he received plus any

---

[91] 639 N.W. 2d at 93. A partnership is a pass-through entity that files a tax return but does not pay tax. Tax is paid by each partner on his/her ratable share of partnership income and deductions. See IRC § 701, 26 U.S.C. §701.

[92] 376 N.W. 2d 274 (Minn. 1986).

[93] *Id.* at 276. The numbers in the opinion do not quite add up to the total sales price specified in the opinion.

pecuniary loss suffered as a consequence of the misrepresentation.[94] Since the plaintiff sold the property for its full value and since the judge had also instructed the jury not to consider taxes paid as an element of damages, the jury found that no damages were incurred.[95]

On appeal, the Minnesota Court of Appeals reversed and held that the plaintiff was entitled to damages flowing from the defendant's negligent misrepresentation that he could structure a "no-tax" sale. According to the Appeals Court, subject to meeting his burden of proof, the plaintiff could recover the difference between the $98,000 in taxes incurred on the sale and the lesser amount of taxes that would have been incurred if the sale were structured differently.[96]

What seems very odd about this measure of damages is that in no way does it take into account the tax professional's promise of a "no tax" sale. Given accurate advice the plaintiff may have chosen not to sell the property at all, or certainly not to sell it on terms that provided virtually no cash up front.

In *Eckert Cold Storage, Inc. v. Behl*,[97] the court also seems to have utilized a measure of damages similar to that utilized in *Whitney*. In *Eckert* the defendant accountant apparently rendered incorrect advice that confirmed the availability of grossly exaggerated tax benefits that the court later characterized as illusory and fanciful.[98] In *Eckert* the plaintiffs sued under a theory of common law misrepresentation. Under applicable California law, the measure of damages was "the amount which will compensate for all the detriment proximately caused"

---

[94] *Id.* at 279-80.

[95] *Id.* at 277.

[96] *Id.* at 281.

[97] 943 F. Supp. 1230 (E.D. Cal. 1996).

[98] *Id.* at 1234.

by the tortious conduct.[99] Although the district court held the measure of damages authorized was not "benefit of the bargain" (*i.e.*, expectation) damages,[100] it did hold that the plaintiffs' tax liability could be recovered under appropriate circumstances. The court held that taxes could be recovered if the plaintiffs could prove that the tax liability was caused by the defendant's negligent or fraudulent advice and would not otherwise have been incurred. To make such a showing, according to the court, the plaintiffs would need to prove they would have sheltered their income in an alternative investment.[101] The court then continued:[102]

> Plaintiffs may not be able to recoup the entire amount of the tax liability given that the TTC program apparently promised fanciful tax benefits like no other shelter. But to the extent that plaintiffs would have avoided some of the tax liability through investment in shelters that were available to them at the time, they may recover as damages a portion of the tax liability.

Again, as in *Whitney*, the court is limiting the damage award to the difference between the taxes paid and a lower amount of taxes that could legitimately have been accomplished. There is no reference at all in determining the damages to the level of taxes promised by the defendant tax professional.

---

[99] *Id.* at 1233. (quoting Cal. Civ. Code § 3333).

[100] *Id.* at 1233-34. The court characterized the California measure of damages as being limited to the losses proximately caused by the defendant's misrepresentations, and that the damages should place the plaintiffs in the position they would have been had the misrepresentation not occurred. *Id.* at 1234.

[101] *Id.* at 1234.

[102] *Id.*

In both *Whitney* and *Eckert* it seems a more appropriate measure of damages would be the difference between the promised and the actual tax results. In both situations the plaintiffs took significant actions based upon the defendant's tax advice. In *Whitney* the plaintiff sold assets he otherwise might not have sold, or might not have sold on those terms, and in *Eckert* the plaintiff invested in an ineffective tax shelter. In both situations the plaintiffs might never have engaged in the transaction involved had they been apprised of the actual tax costs, rather than the exaggerated promises of the tax advisors. It seems unfair to limit the damages recoverable by the amount of optimal taxes obtainable, a number the plaintiffs never heard mentioned before engaging in the transactions.

While treating the difference between the promised and the actual tax results as recoverable damages may seem harsh at first glance, and perhaps even contrary to the normal assumption in the professional malpractice context that an attorney [and likely also an accountant] is not a guarantor of his/her advice, it is suggested that such a result is appropriate. Under the damages standard used by the *Whitney* and *Eckert* courts an unscrupulous professional could lure clients from a careful professional by simply promising either a "no tax" sale or the existence of "fanciful" tax deductions. Later, when proven wrong, the damages would simply be the difference between actual taxes incurred and any lower taxes that could have been legitimately achieved – an amount that might even be zero, if the professional structured the transaction correctly; or if the plaintiff simply cannot meet his burden of proof. There is no incentive for the unscrupulous tax professional to render accurate advice. "Pie-in-the-sky" promises of tax benefits will become the norm.

Though I am convinced that a more appropriate result would be obtained if the measure of damages were the difference between the promised and the achieved tax benefits (expectation damages), there is a possible downside to this measure of damages that should be noted. This could occur if a sophisticated, but unscrupulous, client who is aware of the measure of damages were to shop around among tax advisors until he or she locates one who either carelessly or intentionally overstates the tax benefits, or understates the tax costs, of a proposed transaction. Relying on this measure of damages and on the advisor's (or the malpractice insurer's) wherewithal, the client could then obtain the too-good-to-be-true tax benefits via a malpractice suit.

2. Interest

Whenever a taxpayer underpays a tax liability, interest on the underpayment is normally imposed by both federal[103] and state [104] law. Such interest payment therefore is present in many tax malpractice situations and the issue addressed is whether such interest is recoverable as damages.

Before turning to this issue, it is necessary to distinguish this type of interest, which constitutes core damages and which is the subject of the present discussion, from other claims for interest that might be encountered, the recoverability of which will be addressed elsewhere.[105] For instance, under local law if a judgment is obtained by a plaintiff, pre and post judgment interest might also be recovered.[106] Similarly, interest costs may be incurred by a plaintiff as consequential damages. For instance, if due to a tax advisor's negligence a

---

[103] *See e.g.*, IRC §§ 6621-22, 26 U.S.C. §§ 6621-22.

[104] *See e.g.*, N.Y. McKinney's Tax L. §684; Cal. Rev. & Tax L. §19101; Texas Tax L. § 33.01

[105] See Part III B.5., *infra.*

[106] *See e.g.*, Jobe v. International Insurance Co., 933 F. Supp. 844, 860 (D. Ariz. 1995) *order withdrawn pursuant to settlement,* 1 F. Supp. 2d 1403 (D. Ariz. 1997) (prejudgment interest); Wynn v. Estate of Holmes, 815 P. 2d 1231, 1235-36 (Okla. Ct. App. 1991) (prejudgment interest), *overruled by* Stroud v. Arthur Anderson & Co. 37 P. 3d 783 (Okla. 2001); Hagen v. Simmerly 2007 WL 2233410 (Wash. App. 2007) (post-judgment interest); Bear Creek Master Ass'n v. Edwards, 2007 WL 2040611 (Cal. App. 2007) (post-judgment interest).

plaintiff incurs avoidable taxes and pays the taxes with borrowed funds, the interest on the borrowed funds might be recoverable as consequential damages.[107] Similarly, where a negligent tax advisor prevents a plaintiff from obtaining low-cost tax-exempt financing thereby forcing the plaintiff to incur much higher conventional market rate financing, the additional interest might be recoverable as consequential damages.[108]

With respect to the recoverability of interest on a tax underpayment three views have developed. According to one view, that is probably the majority view,[109] such interest is

---

[107] *See e.g.,* Wynn v Estate of Holmes, *id. See generally*, Part III.B.5. *infra*.

[108] *See e.g.,* Billings Clinic v. Peat Marwick Main & Co., 797 P.2d 899 (Mont. 1990)

[109] I am very wary of engaging in a numbers game tallying up the states following each view because it is often difficult to characterize precisely what a court is doing. For instance, in O'Bryan v. Ashland, 717 N.W.2d 632 (S.D. 2006), the South Dakota Supreme Court directly faced this issue of whether interest paid on a tax deficiency may be recoverable as damages from a negligent tax advisor. At the beginning of its opinion the court indicated that this issue was "never before decided in South Dakota." *Id*. at 633. Later in the opinion, in a footnote, the court indicated that a New Jersey federal district court in Ronson v. Talesnick, 33 F. Supp. 2d 347 (D.N.J. 1999) had listed South Dakota among the jurisdictions allowing the recovery of such interest based on an earlier case, Lien v. McGladrey & Pullen, 509 N.W.2d 421, 426 (S.D. 1994). While agreeing with the principle of law quoted by *Ronson* from *Lien*, the South Dakota Supreme Court emphatically stated that *Lien* had never decided the issue and that the court was doing so only in the present *O'Bryan* case. *Id*. at 638 n. 9.

Similarly, while Alaska is listed as a state following the no recovery of interest view based on Orsini v. Bratten, 713 P.2d 791, 794 (Alaska, 1986), nevertheless, several courts in other states have utilized language from a later Alaska case, Thomas v. Cleary, 768 P.2d 1090 (Alaska 1989), as support for the proposition that such interest is recoverable. *See e.g.,* Jobe v. International Insurance Co., 933 F. Supp 844, 860 (D. Ariz 1995) *order withdrawn pursuant to settlement*, 1 F. Supp. 2d 1403 (D. Ariz. 1997); and Dail v. Adamson, 570 N.E.2d 1167, 1169 (Ill. App. 1991).

If a tentative tally is to be attempted the starting point is an article published in March, 2000, in which the author listed four states in the no interest recovery view and fourteen states in the interest recovery view. However, two of the fourteen must be eliminated because one is New Jersey, which, based on Ronson v. Talesnick, is one of the two leading cases in the intermediate view category and the author counted Illinois twice. See Caroline Rule, What And When Can A Taxpayer Recover From A Negligent Tax Advisor, 92 J. Taxation 176, 177-78 (March, 2000). To this four to twelve tally, I would add two states to the no interest recovery view (Massachusetts and Nebraska, Sorenson v. H&R Block, Inc., 2002 U.S. Dist. LEXIS 18689 at * 45-46 (D. Mass. 2002); and J.D. Warehause v. Lutz & Co., 639 N.W. 2d 88, 92 (Neb. 2002) (citing trial court's refusal to treat such interest as recoverable damages)) and possibly one or two other states (i.e., Florida and /or North Carolina, Loftin v. KPMG LLP, 2002 U.S. Dist LEXIS 26909 at * 24 (S.D. Fla 2003) (not clear if court utilized Florida and/or North Carolina law). I would also add three states to the can recover interest list (Pennsylvania, Louisiana and Iowa, Amato v. KPMG LLP, 2006 WL 2376245 (M.D. Pa. 2006), Slaughter v. Roddie, 249 So.2d 584 (La. Ct. App. 1971) Cameron v. Montgomery, 225 N.W. 2d 154, 155 (Ia. 1975) and probably also a fourth (North Carolina; Estate of Smith v. Underwood, 487 S.E.2d 807 (N.C. App 1997), though the federal district court in *Loftin*, *id*., may have assumed North Carolina law to be the opposite.

recoverable from a defendant just as any other damages proximately caused.[110] A second view, diametrically opposite, and likely the minority view, absolutely prohibits the recovery of such interest.[111] A third view, a middle view followed in several states, permits the recovery of such interest but only to the extent it exceeds the interest actually earned by the plaintiff on the underpaid taxes.[112]

The starting point in this inquiry is the traditional and, probably, majority view that since the defendant's negligence caused the plaintiff to incur the interest expense as well as the additional taxes, the interest is recoverable under the normal theory of damages which is to make the plaintiff whole. Thus, many cases simply include such interest as an element of recoverable damages.[113]

My tentative tally would therefore be 6 (maybe 7 or 8) no interest recovery states to 15 (maybe 16) interest recovery states. The new emerging intermediate view would seem to have 2 states, and perhaps as many as 4. *See infra* text accompanying notes 123-59.

[110] *See e.g.* O'Bryan v. Ashland, 717 N.W.2d 632 (S.D. 2006); King v. Neal, 19 P.3d 899 (Okla. Civ. App. 2001); Merriam v. Continental Casualty Co. 597 N.W. 2d 774 (Wis.Ct. App. 1999); McCulloch v. Price Waterhouse LLP, 971 P.2d 414 (Ore.Ct. App. 1998); Estate of Smith v. Underwood, 487 S.E. 2d 807 (N.C. Ct. App. 1997); Jamison, Money, Farmer & Co. v. Standeffer, 678 So. 2d 1061 (Ala. 1996); Jobe v., International Insurance Co., 933 F. Supp. 844 (D. Ariz. 1995) *order withdrawn pursuant to settlement*, 1F. Supp. 2d 1403 (D. Ariz. 1997); Hall v. Gill, 670 N.E.2d 503 (Ohio Ct. App. 1995). Jones v Childers, 1992 WL 300845 (DC Fla.); Jerry Clark Equip. Inc. v. Hibbits, 612 N.E. 2d 858 (Ill. App. Ct. 1993), Harrell v. Crystal, 611 N.E.2d 908 (Ohio Ct. App 1992); Wynn v. Estate of Holmes, 815 P. 2d 1231 (Okla. Ct. App. 1991), *overruled on another issue by* Stroud v. Arthur Anderson & Co., 37 P. 3d 783 (Okla 2001); Dail v. Adamson, 570 N.E.2d 1167 (Ill. App Ct. 1991); Warmbrodt v. Blanchard, 692 P. 2d 1282 (Nev. 1984); Wyatt v. Smith, 1993 WL518630 (Ohio Ct. App); Adel v. Parkhurst, 681 P. 2d 886 (Wyo. 1984); Sorenson v. Fio Rito, 413 N.E. 2d 437 (Ill. App. Ct. 1980); Cameron v. Montgomery, 225 N.W. 2d 154 (Iowa 1975); Slaughter v. Roddie 249 So. 2d 584 (La. Ct. App. 1971).

[111] *See e.g.,* J.D. Warehouse v. Lutz & Co., 263 Neb. 189 (Neb. 2002); Sorenson v. H & R Block, 2002 U.S. Dist LEXIS 18689 at * 45-46 (D. Mass 2002); Leendertsen v. Price Waterhouse, 916 P. 2d 449 (Wash Ct. App. 1996); Eckert Cold Storage, Inc. v. Behl, 943 F. Supp. 1230 (E.D. Calif. 1996); Alpert v. Shea Gould Climenko & Casey, 559 N.Y.S. 2d 312 (1st. Dept. 1990); Orsini v. Bratten, 713 P. 2d 791, 794 (Alaska, 1996). *See also* Loftin v. KPMG LLP, 2002 U.S. Dist. LEXIS 26909 at *23-24 (S.D. Fla.)

[112] Ronson v. Talesnick, 33 F. Supp. 2d 347 (D.N.J. 1999); Streber v. Hunter, 221 F. 3d 701 (5th Cir/ 2000). *See also* O'Bryan v. Ashland, *supra* n. 110, and McCulloch v. Price Waterhouse, *supra* n. 110. See text accompanying notes 146-59 *infra*).

[113] *See e.g.,* King v. Neal, *supra* note 110; Merriam v. Continental Casualty Co., *supra* note 110; Jobe v. International Insurance Co., *supra* note 110; Jerry Clark Equip. Inc. v. Hibbits, *supra* note 110; Harrell v. Crystal, *supra* note 110; Dail v. Adamson, *supra* note 110.

The basic reason for the opposite view denying recovery of the interest is that to permit a recovery of the interest would result in a windfall for the plaintiff. The plaintiff would have both the use of the tax money as well as a recovery of the interest paid for the use of that money.[114] According to this view, the interest charged for a tax underpayment is not a penalty imposed upon the taxpayer. Rather, it is merely a charge for the use of money that really belonged to the IRS rather than the plaintiff.[115] To put it differently, allowing the plaintiff both use of the tax money and a recovery of the interest from the defendant results in an interest free loan to the plaintiff for the period during which the taxes were unpaid.[116] This view follows the approach of federal securities law for securities fraud claims under Rule 10b-5 where such interest also is not recoverable.[117]

Leendertsen v. Price Waterhouse,[118] which adopted the no interest recovery view in Washington State suggested two additional justifications for this result: first, that a defendant may not be held responsible for such damages since there is no proximate causation because the rate of return earned by a plaintiff on such funds is due to the plaintiff's exercise of independent judgment as to where to invest the money. The court seemed to be concerned

---

[114] See cases cited *supra,* note 111.

[115] *See e.g.,* O'Bryan v. Ashland, *supra* note 110, 717 N.W. 2d at 637.

[116] Caroline Rule, *supra* n.109 at 177.

[117] Streber v. Hunter, 221 F.3d 701, 734 (5th Cir. 2000) citing DCD Programs, LTD. v. Leighton, 90 F. 3d 1442, 1449 (9th Cir. 1996); Stone v. Kirk, 8 F. 3d 1079, 1092 (6th Cir. 1993) and Freschi v. Grand Coal Venture, 767 F. 2d 1041, 1051 (2d Cir. 1985), *vacated on other grounds*, 478 U.S. 1015 (1986), *on remand*, 800 F. 2d 305 (1986), *decision amended*, 806 F. 2d 17 (1986). *Alpert* relied on *Freschi* in denying any recovery of such interest 559 N.Y.S. 2d at 315.

[118] 916 P. 2d 449 (Wash. App. 1996)

that damages from poor investing are too speculative to blame upon a defendant. Second, the court was concerned with the difficulty of proving where the money was invested.[119]

In *McCulloch v. Price Waterhouse LL.P.*,[120] the Court of Appeals of Oregon gave short shrift to these points. Here too the court, as a matter of first impression,[121] was faced with the decision of whether interest paid on a tax underpayment is recoverable as damages. In deciding contrary to *Leendertsen* that such interest is recoverable, the court simply held that similar issues were dealt with satisfactorily under Oregon law either by the jury, where enough evidence to get to a jury was introduced by the plaintiff, or else, if there was inadequate evidence to get to a jury, by the court directing a verdict.[122] In other words, such issues were properly to be determined by the trier of fact.

The intermediate view between the extremes of the previous two views was developed in *Ronson v. Talesnick*[123] and *Streber v. Hunter*.[124] It seems to be a reaction primarily to the harsh results that may occur from a rigid application of the no interest recovery view. Thus, while the logic of the no interest recovery view initially seems compelling in that once a plaintiff obtains and keeps money she or he is not entitled to, later when the money is repaid it seems appropriate to impose interest on the plaintiff for the use of this money. If this interest were recoverable from the defendant, logic suggests the plaintiff enjoys a windfall of having enjoyed the interest-free use of the money. However,

---

[119] *Id.* at 451-52.

[120] 971 P. 2d 414 (Ore. 1998).

[121] *Id.* at 417.

[122] *Id.* at 419.

[123] 33 F. Supp. 2d 347 (D.N.J. 1999)

[124] 221 F. 3d 701 (5th Cir. 2000)

simply denying any recovery of such interest is based on the tacit assumption that the theoretical value of the use of the money is always exactly equal to the interest paid the IRS (and/or state) and that these amounts always net out leaving no net recoverable damages. However, there are several practical problems with this theoretical scenario. As an initial matter, the theoretical scenario assumes the plaintiff taxpayer has available money to invest equal to the tax underpayment, the earnings on which offset the interest charged for the underpayment. Frequently, a plaintiff will not have any available funds to invest so that there are no earnings to offset the interest payable to the IRS.[125] Additionally, the theoretical scenario assumes the taxpayer can earn a rate of return on his or her investable funds equal to the interest charged by the IRS, which often may not be true. Finally, the no interest recovery approach does not take into account the hardship to a plaintiff who has to make an unexpected payment which may not have been budgeted.[126]

In *Ronson v. Talesnick*[127] the plaintiff taxpayer had invested in tax shelter partnerships during 1980 through 1983 and claimed losses from the partnerships on his tax returns. Subsequently the IRS began questioning the deductibility of these losses. In mid-1986 the taxpayer sought advice form the defendant accountant on how to stop the accrual of interest on the amount that would be owed the IRS if these losses were ultimately disallowed. The accountant advised the taxpayer to send the IRS a cash bond for $91,300 which the

---

[125] *See e.g.,* Wynn v. Estate of Holmes, 815 P. 2d 1231, 1235 (Okla. App. 1991) *overruled on other issue by* Stroud v. Arthur Anderson, 37 P. 3d 783 (Okla. 2001);

As a theoretical matter, even if the plaintiff does not have financial liquidity and does not have available an amount of such funds to invest, the financial benefit of having had the government's funds still has occurred. In the absence of the tax underpayment, the plaintiff may have had to either do without certain expenditures or else borrow a similar amount to meet his or her needs, thereby benefiting by the amount of interest not incurred.

[126] See Caroline Rule, *supra* note 109 at 177.

[127] *Supra* note 123.

taxpayer did in June, 1986. In 1996 the IRS audited the taxpayer and it was determined that the cash bond was too low and interest of approximately $235,000 was still owed.[128] This suit followed, seeking recovery from the accountant of the additional interest owed by the taxpayer.

The only damages sought by the plaintiff in *Ronson* was the interest owed the IRS. The defendant moved for summary judgment dismissing the action on the ground that interest is never recoverable as damages and that the suit therefore must be dismissed since an essential element of the cause of action, *i.e.*, damages, was absent.[129] In *Ronson* the federal district court determined that New Jersey law applied and that New Jersey had no law on point. The court therefore had to determine how the New Jersey Supreme Court would rule on this issue.[130]

In deciding the issue, the court in *Ronson* initially recognized the split between the no interest recovery and the interest recovery views. Based on New Jersey's public policy that a tortfeasor should not benefit from the ingenuity of a harmed plaintiff,[131] the court decided that New Jersey would permit the recovery of interest. According to the court, prohibiting the recovery of interest from a negligent accountant:

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

[128] 33 F. Supp. 2d at 349-50.

[129] *Id.* at 351.

[130] *Id.* at 351-52.

[131] *Id.* at 355. The court surmised that this was the New Jersey public policy underlying its collateral source rule. *Id.*

> earned interest in an amount comparable to the interest rate charged by the IRS.[132]

Ronson, however, did not hold that New Jersey simply would adopt the view allowing recovery of the interest. *Ronson* held that New Jersey law is more circumscribed. It found that New Jersey follows a benefits rule that: "where a wrong creates a benefit that would not have existed but for the wrong, the damages flowing from the wrong are offset to the extent of the benefit received."[133]

Under this rule a defendant could introduce evidence of a benefit from the malpractice that could lessen a plaintiff's recovery.[134] Thus, where a plaintiff earned some interest on the tax underpayment, but less than the amount paid to the IRS, the interest recovery would be limited to the difference.

In *Streber v. Hunter*[135] the Fifth Circuit affirmed a damage award of exactly the same amount, which the court referred to as the "interest differential" -- *i.e.*, the difference between the interest earned by the plaintiff while she had the tax underpayment and the interest charged by the IRS.[136] *Streber* involved a combination of bad advice by the defendant attorney about how to report a transaction for tax purposes as well as subsequent bad advice not to settle the controversy with the IRS on favorable terms. At the jury trial below the most

---

[132] *Id.*

[133] *Id*. at 354.

[134] *Id.* at 355.

[135] 221 F. 3d 701 (5th Cir. 2000).

[136] *Id*. at 734.

significant element of damages awarded was for the interest differential. On appeal the defendants argued that such interest was not recoverable.[137]

At the commencement of its analysis, the Fifth Circuit noted that the issue was one of first impression in that court as well as in any court.[138] The court recognized the split between the no interest recovery and the interest recovery views,[139] and also recognized that no interest recovery was permitted for federal securities fraud claims under Rule 10b-5.[140] The Fifth Circuit then held that the interest differential was recoverable since by awarding only the interest differential there was no double recovery as there would be if the plaintiff could recover all the interest paid the IRS. Also an award of the interest differential prevents a plaintiff from being penalized for conservative investing.[141] The Fifth Circuit held that the result was correct under the applicable Texas law which required damages adequate to make a plaintiff whole.[142] Likewise, the Texas law's requirement that consequential damages be "foreseeable" and proven with "reasonable certainty" was complied with since the evidence established that the defendant knew that the plaintiffs intended to invest conservatively.

---

[137] *Id.*

[138] *Id.* Strangely, the court cited the *Ronson* case at the end of the very paragraph in which it made this statement, apparently without realizing that *Ronson* had addressed the same issue. The Fifth Circuit simply cited *Ronson* as one of the accountant malpractice cases allowing the recovery of interest. Perhaps the Fifth Circuit intended its observation to be directed at attorney tax malpractice rather than accountant tax malpractice. However, the *Alpert* case cited by the court as one of the accountant malpractice cases involved attorneys as defendants. *Jobe v. Int'l Ins. Co.* similarly involved tax malpractice by an attorney though the case was brought by an insured law firm against its malpractice insurer.

[139] Id. The Fifth Circuit referred to this split as involving accounting malpractice claims, though two of the five cases cited by the court involved attorneys (*Alpert and Jobe v. Int'l. Ins. Co.* (actually involved suit between an insured law firm and its malpractice insurer)).

[140] *Id.*

[141] *Id.* at 734-35.

[142] *Id* at 735

Also, there was abundant evidence establishing exactly how much the plaintiffs earned from the tax underpayment and how much the IRS charged.[143]

While *Streber* seemed to uphold an award of exactly the same amount as contemplated in *Ronson* there seems to be a very important procedural difference between the two approaches. In *Ronson* the court awarded the plaintiff the full interest paid to the IRS, subject to the defendant being able to prove the existence of a benefit (*i.e.*, earnings) received by the plaintiff that should reduce the plaintiff's recovery.[144] In *Streber*, on the other hand, the plaintiff had the burden of proving the interest differential with "reasonable certainty."[145]

Before leaving this area three additional cases merit discussion. In *O'Bryan v. Ashland*,[146] the Supreme Court of South Dakota was called upon to decide the issue of whether such interest is recoverable. Here the case involved an error by the defendant accountant concerning the incorporation of plaintiff's business and the change from the cash method of accounting to the accrual method of accounting.[147] The accountant's error resulted in a substantial underpayment of tax which the IRS later discovered and for which the IRS imposed an interest change on the plaintiff. At trial, the defendant accountant conceded his negligence and the only issue was the damages recoverable.[148] At trial both

---

[143] *Id.*

[144] 33 F. Supp 2d at 355.

[145] 221 F. 3d at 735

[146] 717 N.W. 2d 632 (S.D. 2006).

[147] For a very brief overview of tax accounting methods, *see* John E. Davidian & Jacob L. Todres, REDUCING PERSONAL INCOME TAXES: A GUIDE TO DEDUCTIONS AND CREDITS, §1.06 (Law Journal Seminars Press 1995).

[148] 717 N.W.2d at 634.

parties had extensively argued before the jury whether interest was recoverable and the jury ultimately awarded the plaintiff the interest charged by the IRS that was later calculated to be around \$39,000.[149] On appeal the issue was whether such interest may be recovered as damages under South Dakota law.

After recognizing the existing split between the no interest recovery and interest recovery views, and examining each view, the South Dakota Supreme Court placed itself firmly with those states which refuse to adopt a blanket no interest recovery rule. The court did this in conformity with its own precedent requiring the injured party be made whole.[150] After concluding that such interest may be recoverable, the court affirmed the jury award of interest as being supported by the evidence. The court then went on to seemingly endorse the approach taken by *Ronson* to allow a defendant to come forward with evidence of a benefit received by the plaintiff from the malpractice that would reduce the plaintiff's recovery.[151] Such an approach would cut a pragmatic course between the two rigid extreme views.[152] However, the court stopped short of adopting the *Ronson* approach and left that for a future case.[153]

What is notably absent from *O'Bryan's* analysis is any discussion of, or even reference to, the *Streber* case, which essentially follows *Ronson* and, together with *Ronson*, seems to anchor the intermediate view on this issue.

---

[149] *Id* at 636.

[150] *Id.* at 638-39.

[151] *Id* at 639-40.

[152] *Id.* at 640.

[153] *Id.*

In *Amato v. KPMG LLP* [154] the federal district court in Pennsylvania followed *O'Bryan*, after agreeing that it "provides an excellent template for surveying the legal debate about recovery of interest paid to the IRS."[155] In *Amato* the district court was applying Pennsylvania law. After noting that Pennsylvania had no law on point and after analyzing the split in authority, the court held:[156]

> the better practice is to reject a blanket rule forbidding interest recovery in professional malpractice actions. Instead, we align ourselves with those jurisdictions that leave the issue as to whether a taxpayer has been damaged to the trier of fact, with the burden of proof upon the taxpayer. Therefore, we conclude that interest paid to the IRS may be a recoverable element of damages, depending upon the facts of the case.

The third case that merits some brief discussion is *McCulloch v. Price Waterhouse LLP*,[157] decided about seven weeks before *Ronson*. In refusing to follow the no interest recovery view, the opinion contains some language reminiscent of *Ronson's* approach. In *McCulloch*, in response to an argument based on *Leendertsen* that such interest damages are

---

[154] 2006 WL 2376245 (M.D. Pa.). The procedural posture of *Amato* is fascinating. At the heart of the case is a claim by the plaintiffs that the defendants put them in an ineffective tax shelter prevalent in the late 1990's to early 2000's. The complaint was filed in Pennsylvania court on October 28, 2005. It was removed to the Pennsylvania federal district court on January 6, 2006. On June 13, 2006, the court issued an Order addressing a number of different motions made by the parties. Without really focusing on the issues surrounding the recoverability of interest, the court granted one of the defendant's motions which resulted in precluding the plaintiffs from recovering any interest paid to the IRS. The *O'Bryan* case was issued on June 21, 2006, and the present Motion for Reconsideration of the preclusion of any interest recovery was filed on June 27, 2006. *Id*. at *1.

[155] *Id*. at *5.

[156] *Id*. at *6
.
[157] 971 P. 2d 414 (Ct. App Ore. 1998).

speculative and therefore ought not be recoverable, the Oregon Court of Appeals stated that a plaintiff retains the burden of proof of the causation and the amount of each claim for damages and that, to the extent a defendant chooses to contend that the plaintiff failed to mitigate damages, discovery is available to augment such allegation.[158] If the reference to mitigation of damages could be deemed to allow a defendant to reduce recoverable damages by the earnings received by the plaintiff on the tax underpayment, this would be almost identical with the recovery permitted in *Ronson*. The only difference would be of nomenclature. *Ronson* refers to the reduction of recoverable damages as being under New Jersey's benefit rule, while *McCulloch* refers to the reduction as being rather than by reason of mitigation.

One additional point adverted to in *McCulloch* is noteworthy, and, in appropriate circumstances, might suggest an additional windfall type argument in favor of the no interest recovery view. *McCulloch* intimates that allowing recovery of interest might be duplicative of prejudgment interest in jurisdictions where prejudgment interest is also awarded.[159]

3. Penalties

There are a number of provisions in the Internal Revenue Code that impose penalties upon taxpayers in various circumstance. For instance, among others, penalties are imposed for late filing of required tax returns,[160] for underpayments of tax for accuracy-related reasons, such as where the underpayment is due to negligence or disregard of rules or regulations, where the understatement is substantial or where there is a substantial valuation

---

[158] *Id.* at 419.

[159] *Id.*

[160] IRC § 6651(a); 26 U.S.C. § 6651(a).

misstatement,[161] and for fraud.[162] States have a similar panoply of penalty provisions.[163] Thus, when a tax advisor is negligent, often a tax penalty is suffered by the taxpayer. If the injured taxpayer is to be made whole, such penalties need to be recovered. By and large, the decided cases have shown no reluctance to include such penalty amounts in recoverable damages.[164] Unlike the situation with interest imposed on an injured taxpayer where the taxpayer has had the benefit of having money not belonging to him for a period of time, and three different views have developed, the incurrence of a penalty is simply damages flowing directly from the tax advisor's negligence, and the recovery of such amounts is not controversial.

In connection with the recovery of penalties as damages two further observations are offered. First, in *Sorenson v. H&R Block*,[165] the court did state that it would not permit the recovery of interest and penalties because the court would follow the no interest recovery view represented by the *Alpert* case rather than the contrary view represented by the *Eckert Cold Storage* case.[166] However, it appears that the court simply made an unwarranted slip of

---

[161] IRC § 6662(a) and (b); 26 U.S.C. § 6662(a) and (b).

[162] IRC § 6663; 26 U.S.C. § 6663.

[163] *See e. g.,* N.Y. McKinney's Tax L. §685; Cal. Rev & Tax L. §19131-33; Texas Tax L §33.01.

[164] *See e.g.*, King v. Neal, *supra* n. 110; Merriam v. Continental Casualty Co., *supra* n. 110; Estate of Smith v. Underwood, *supra* n. 110; Hall v. Gill, *supra* n. 110; Jerry Clark Equipment Inc. v. Hibbits, *supra* n. 110; Dail v. Adamson, *supra* n 110; Sorenson v. Fio Rito, *supra* n 110; Cameron v. Montgomery, *supra* n. 110; Slaughter v. Roddie, *supra* n. 110.

[165] 2002 U.S. Dist. LEXIS 18689 (D. Mass. 2002).

[166] *Id.* at *45-46. See also Blumberg v. Altman, 2007 WL 1519067 (Sup. Ct. N.Y. Co. 2007), in which the court explicitly held that *Alpert's* holding that interest is not recoverable as damages in New York does not apply to penalties. *Id*. at *2.

In *Sorenson*, the court indicated that the majority view was the no recovery of interest view of *Alpert* and cited *Eckert Cold Storage* for this. *Id.* As indicated above, see note 109, *supra*, I believe this is actually the minority view.

the tongue in referring to penalties as well as interest – the way people normally refer to tax, interest and penalties as a unit– rather than a considered attempt to change established law or break new ground. Certainly the court's reference to both *Alpert* and *Eckert Cold Storage* reinforces this conclusion since both cases addressed only interest, not penalties. In any event, this language in *Sorenson* seems to be only dicta since the court's focus on interest and penalties was ancillary to its focus on the recoverability of the taxpayer's taxes, which, in any event, were held not to be recoverable.[167] *Sorenson*, incidentally, was addressing the recoverability of damages solely under a breach of contract cause of action for breach of the defendant return preparer's promise of confidentiality.[168] In any event, no other case follows *Sorenson* on this point.

The second observation is to take note of the somewhat ingenious, but ultimately incorrect, argument raised by the defendant in *Bick v. Peat Marwick and Main*.[169] In *Bick* the defendant accounting firm attempted to avoid liability for the negligence penalty incurred by the plaintiff taxpayer as a result of the defendant's error in omitting income from the plaintiff's tax return. The defendant accounting firm, Peat Marwick, argued that an award of damages for a civil penalty imposed on a taxpayer somehow contravenes public policy that there be no indemnification for penalties.[170] Cutting through Peat Marwick's argument based on cases in a different context, the court held that the IRC penalties involved are not criminal but civil penalties that are merely collection devices.[171] The court held no cases were

---

[167] *Id.* at *45.

[168] *Id.* at *42.

[169] 799 P.2d 94 (Kan. Ct. App. 1990).

[170] *Id.* at 101.

brought to its attention that hold there are sound policy reasons to deny indemnity for such penalties. The court also held that an award of damages for such negligence penalties does not contravene public policy.[172] In any event, it seems questionable whether the rules concerning indemnification are relevant to what damages are recoverable in a tort context where the focus is on making an injured plaintiff whole.

(4) Corrective Costs

The fourth element of core damages is corrective costs. These are the costs incurred to mitigate, or attempt to mitigate, the damages incurred. When tax malpractice occurs either in return preparation or tax planning normally there will be a need to file late or amended tax returns. If an audit occurs as a result of the negligence, representation at the audit by either an attorney or accountant will be necessary. Often, subsequent representation at administrative or legal proceedings will also be necessary to either attempt to salvage the desired tax treatment or to attempt to eliminate or minimize interest, penalties or other negative tax consequences caused by the malpractice. All these and any other similar mitigation costs are the corrective costs addressed herein. If the malpractice occurs in a litigation situation, the corrective costs would normally be costs incurred to hire counsel (and perhaps experts) to attempt to undo the mistakes of the negligent counsel.

Although there do not seem to be many reported cases involving litigation-related errors, it is well established that corrective costs are recoverable as damages.[173] In several

[171] *Id.* at 101-02.

[172] *Id.* at 102.

cases where the defendants vigorously litigated the issue of whether interest on a tax underpayment is recoverable, they did not even bother to challenge the award of corrective costs as damages.[174]

Conceptually, the recovery of such corrective costs is necessary in order to make the plaintiff whole. These are costs flowing directly from the negligence of the defendant.[175] Additionally, the requirement imposed upon a victim of negligence to mitigate his damages also dictates that such steps be taken to mitigate the damages and, concomitantly, that their costs be recoverable.[176]

The only potential confusion that is sometimes encountered in this area arises from the fact that the general approach in the United States is not to award attorneys fees for a plaintiff's representation in a malpractice litigation.[177] While this "American View" has absolutely no relevance to the recovery of corrective costs, defendants often attempt to obfuscate and argue that legal fees paid for corrective actions are within the ambit of the American View's disallowance of the recovery of legal fees.[178] Most of the time the courts have no trouble distinguishing these two:[179]

---

[173] *See e.g.*, J.D. Warehouse v. Lutz & Co., *supra* n. 111; King v. Neal, *supra* n. 110; John Kohl & Co. v. Dearborn & Ewing, 1997 WL 195469 (Tenn. App.); Jobe v. Int'l. Ins. Co. *supra* n. 110; 933 F. Supp. at 860; Lien v. McGladrey & Pullen, 509 N.W.2d 421, 425-26 (S.D. 1993); Jerry Clark Equipment, Inc. v. Hibbits, *supra* n. 110; Wirtz v. Switzer, 586 So. 2d 775, 782 (Miss. 1991); Levin v. Berley, 728 F.2d 551, 554 (1st Cir. 1984); Sorenson v. Fio Rito, *supra* n. 110; Slaughter v. Roddie, *supra* n.110. C*f.* Henderson v. Domingue, 626 So.2d 555 (La. App. 1994) (in litigation malpractice court seems to imply that mitigation costs could have been recovered, if they had been incurred. See *id.* at 560).

[174] *See e.g.,* O'Bryan v. Ashland, *supra*, 717 N.W.2d at 636 n.7; Leendertsen v. Price Waterhouse, *supra,* 916 P. 2d at 450-51.

[175] Sorenson v. Fio Rito, *supra*, 413 N.E.2d at 52.

[176] *See e.g.*, WOLFMAN ET. AL. *supra* n. 16 at § 605.2.1 at pp 506-07; 3 MALLEN & SMITH, *supra* note 1, §20.10 at 28-29.

[177] *See e.g.,* Sorenson v. Fio Rito, *supra*, 413 N.E.2d at 51-52; Slaughter v. Roddie, *supra,* 249 So. 2d at 586. *See infra* text accompanying notes 305-08.

> It is clear from this statement that the policy against awarding attorneys' fees was intended to apply only where a successful litigant seeks to recover his costs in maintaining the lawsuit. We do not believe it was intended to preclude a plaintiff from recovering losses directly caused by the defendant's conduct simply because those losses happen to take the form of attorneys' fees. The plaintiff here is not attempting to recover the attorneys' fees she expended in bringing this lawsuit. Rather, she seeks to recover losses incurred in trying to obtain refunds of tax penalties which were assessed against her solely as a result of the defendant's negligence. Had the plaintiff been forced to hire an accountant to repair the damage caused by the defendant's conduct, she would undoubtedly have been entitled to recover the accountant's fee as an ordinary element of damages. There is no basis in logic for denying recovery of the same type of loss merely because the plaintiff required an attorney instead of an accountant to correct the situation caused by the defendant's neglect. In holding the defendant liable for the plaintiff's losses, we are not violating the policy against "penalizing" a litigant for defending a lawsuit. We are simply following the general rule of requiring a wrongdoer to bear the consequences of his misconduct.

Normally corrective costs predictability would be professional fees either of an attorney or accountant to file late or amended tax returns or to attempt to salvage the desired tax treatment or reduce penalties and/or interest either administratively or through litigation. However, all types of corrective costs are recoverable so long as they are within the jurisdiction's rules for foreseeability or proximateness. Other or different types of costs are more likely to be encountered in tax planning situations, especially estate planning. Examples of such other corrective costs that might arise in the estate planning area are the costs involved to attempt to (1) reform a will, trust or similar document,[180] (2) renounce

---

[178] *See e.g.,* Sorenson v. Fio Rito, *id.* and John Kohl & Co. v. Dearborn & Ewing, *supra* n. 173.

[179] Sorenson v. Fio Rito, *id.*, 413 N.E.2d at 51-52.

[180] *See e.g.*, Jewish Hospital of St. Louis v. Boatmen's National Bank of Belleville, 633 N.E. 2d 1267, 1277 (Ill. App. 1994).

powers or interests in property;[181] or (3) give away property or interests in property.[182] The most unusual illustration of this type of cost, and perhaps the outer limit of what may be recoverable, is demonstrated by *Porter v. Ogden, Newell & Welch*,[183] in which the Eleventh Circuit held that costs to lobby the Florida legislature to change its laws may be recoverable corrective costs.

In *Porter*, a will and trust were prepared by two law firms, the defendants in this action. Under the plan, the settler of the trust was to include the trust corpus in his estate at death. The trust, denominated as a "double generation skipping trust," was designed to protect the trust's corpus from further transfer taxation until the death of the grantor's grandchildren.[184] Under the trust, the settlor's son, Reverend Porter, became co-trustee. For the trust's purpose to be effectuated, it was essential that Reverend Porter not have a general power of appointment over the trust. If he did have such a power, the trust corpus would be included, and taxed, in his taxable estate.[185]

In 1990, Reverend Porter discovered a potential problem with the trust. One of the paragraphs of the trust provided that the trustee had discretion to distribute trust corpus to a beneficiary for the "welfare" of such beneficiary.[186] As both co-trustee and beneficiary, Reverend Porter had the power to distribute trust corpus to himself for his "welfare." Under relevant federal law, if "welfare" was a limited, ascertainable standard, such a power would

---

[181] *See e.g.*, Bucquet v. Livingston, 129 Cal. Rptr. 514, 516 (Ct. App. 1976).

[182] *Id.* Such costs could even include the transfer taxes incurred on such transfers. *Id.* at 515, 517.

[183] 241 F.3d 1334 (11th Cir. 2001). *Cf* Carlson v. Sweeney, Dabagia, Donoghue, Thorne, Janes & Pagos, ___ N.E. 2d ___, 2007 WL 1630413 (Ind. App. 2007) for a similar error.

[184] *Id.* at 1336. It should be noted that current law prevents utilization of such a trust. See IRC §§ 2601-2664.

[185] *Id.* at 1337. See IRC § 2041.

[186] *Id.* at 1336-37

not be tantamount to a general power of appointment.[187] However, if "welfare" had no such limits but was wholly discretionary, this power was tantamount to a general power of appointment.[188] The relevant Treasury regulation indicated that a power to distribute corpus for someone's "welfare" was not limited and was treated as a general power of appointment.[189]

Reverend Porter was advised by his law firm that federal law would look to state law to determine whether "welfare" had an ascertainable standard. However, the relevant Florida law was unsettled as to the meaning of the word "welfare."[190]

In order to solve his problem, Reverend Porter successfully lobbied the Florida legislature to change the law to give the word "welfare" a limited, ascertainable meaning. He then obtained a private letter ruling from the IRS that the corpus of the trust would not be included in his estate under the revised Florida law.[191] To further protect his interests if Florida ever changed the law again, Reverend Porter obtained a judicial reformation of the trust instrument to eliminate the word "welfare" as a scrivener's error. He then obtained a second private letter ruling from the IRS that the judicial reformation would not cause any adverse tax consequences.[192]

After Reverend Porter's death in 1999, the trustees of his estate brought this malpractice action against the attorneys to recover the costs expended in curing this general

---

[187] *Id.* See Treas. Reg. § 20.2041-1(c)(2).

[188] *Id.*

[189] *Id.* at 1337.

[190] *Id.*

[191] *Id.*

[192] *Id.*

power of appointment problem.[193] The federal district court below dismissed the complaint on the ground that it was premature because no damages had yet occurred since the IRS had not yet attempted to impose any taxes on the trust.[194] On appeal the Eleventh Circuit held that under Florida law the costs incurred by Reverend Porter to cure the potential problem were actual damages incurred and that the case was not premature as the district court below held. Accordingly, Reverend Porter, or at least his estate, was entitled to its day in court.

The issue of whether the costs incurred by Reverend Porter, especially the costs of lobbying the Florida legislature are recoverable or are too remote and unforeseeable is most intriguing. While the Eleventh Circuit reversed the district court and held that enough damages were incurred to make the case ripe for adjudication, it also indicated that the plaintiffs had a "difficult" task to prove proximate causation.[195] The Eleventh Circuit avoided addressing any substantive issues since they were not addressed by the district court below.[196]

B. Non-Core (Consequential) Damages

In its attempt to make a plaintiff whole, the law permits recovery for not just the direct damages caused by a defendant, but also for all damages resulting as a consequence of the defendant's negligence.[197] These other, or consequential, damages are not limited to any predefined category or type; instead, so long as the damages are foreseeable and proximately

---

[193] *Id.*

[194] *Id.* at 1338.

[195] *Id.* at 1340. The court, however, focused on the fact that the difficulty in proving proximate causation was because the corrective actions were taken before there was any indication of a problem from the IRS. *Id.*

[196] *Id.*

[197] 3 MALLEN & SMITH, *supr*a note 1, § 20.1; WOLFMAN ET. AL., *supra* note 16 § 605.1.1-2.

caused by the defendant's negligence they are recoverable. In addition to the concepts of proximate causation and foreseeability, the law limits the scope of potentially recoverable damages by use of the doctrine of speculativeness. More specifically, by limiting recoverability to those damages that are not speculative. [198] It should be emphasized that the key determinative factor is whether there are damages, not on the difficulty in calculating their exact amount. [199]

1. Speculativeness

Any attempt to craft general rules to distinguish the speculative from the non-speculative would seem to be an exercise in futility because the decisions seem to be very fact sensitive and also jurisdiction sensitive. With this in mind I shall attempt to simply survey the area by focusing on some of the cases in which speculativeness arose as an issue.

Several of the cases involve whether potentially lost income or investment opportunities may be recovered as damages. In *Olson Clough & Straumann, CPA's* v. *Trayne Properties, Inc.*, [200] the defendant, Trayne Properties, was in the business of syndicating and managing real estate. It had retained the plaintiff CPA firm to prepare tax returns it needed to furnish to certain limited partnerships it managed. Due to various billing disputes and, perhaps also because the individual designated by Trayne to work with the CPA's was not available, the CPA's on several occasions suspended work on the tax returns and then ceased working on them without completing them. Trayne Properties, as a

---

[198] 3 MALLEN & SMITH, *supra,* note 1, § 20.3; WOLFMAN ET. AL., *supra* note 16 § 605.1.1

[199] 3 MALLEN & SMITH, *supra*, note 1, § 20.3 at pp. 10-12

[200] 392 N.W. 2d 2 (Minn. App. 1986).

counterclaim, sought to recover damages from the CPA's for this malpractice.[201] The bulk of the damages sought was for almost $500,000 for the damage to its reputation and the loss of business resulting from Trayne's failure to provide the required tax returns on a timely basis. [202] The Minnesota Court of Appeals affirmed the trial court's holding that such damages could not be recovered because they were too speculative and cannot be determined with a reasonable degree of certainty.[203]

Similarly, in *Orsini* v. *Bratten* [204] the plaintiffs sued their investment advisor/return preparer for misrepresenting the return they would obtain from investing in a purchase and lease-back of equipment. In addition to a calculation mistake, the defendant erroneously assumed the investment was eligible for the investment tax credit. [205] As damages, the plaintiffs sought to recover the difference between their actual return and what they would have received had they invested in certain rental real estate they were considering as an alternative investment [206] The court, however, rejected this as a measure of damages because it was too speculative. [207]

---

[201] *Id*. at 3.

[202] *Id.* at 4. Trayne also sought to recover the value of time it spent when its employees prepared the missing tax returns. Recovery was denied on this claim because Trayne had prepared the returns at less cost than the CPA's would have charged. *Id*. at 3.

[203] *Id*. at 4 – 5.

[204] 713 P. 2d 791 (Ala. 1986).

[205] *Id*. at 792.

[206] *Id*. at 793. Plaintiffs presented an expert witness who quantified their expected return from the real estate investment. *Id*. at note 4.

[207] Id. at 794. This result should be contrasted with Yarbrough v. Cooper, 559 S.W. 2d 917 (Tex. Civ. App. 1977), in which the court did permit the recovery of $43,000 in taxes the plaintiff could have avoided had he invested in certain real estate rather than relying on the defendant who had promised he would take care of his problem, but did nothing. 559 S.W.2d at 920-21.

Contrary to *Olson* and *Orsini,* in *Deloitte, Haskins & Sells* v. *Green*, [208] the court was willing to assume that the plaintiff would continue to operate the business at issue successfully. The court here held this conclusion was not mere speculation where evidence had been introduced that the plaintiff bought the company when it operated at a loss and turned it around into a profitable operation. [209]

In many cases the issue of speculativeness pertains to whether the plaintiff has established the amount of taxes or additional taxes claimed as damages. In *Thomas* v. *Cleary* [210] the defendant accountant was retained to advise the plaintiffs concerning the sale of their business in July 1976. In January, 1978 the accountant advised the plaintiffs they owed an additional $100,000 in taxes on the sale of their business. The accountant, however, never prepared a final tax return for the business and no such return was every filed. The plaintiffs claimed the amount of taxes owing were about $200,000 and instituted this action against the accountant.[211] The jury awarded the plaintiffs damages, including damages for this potential tax liability.[212] The defendant appealed from the judgment on the ground that such damages

---

[208] 403 S.E. 2d 818 (Ga. App. 1991).

[209] *Id*. at 820. Here the plaintiff sold the business and incurred over $650,000 in taxes above the amount the defendant accountants advised he would incur. *Id*. at 819.

[210] 768. P. 2d 1090 (Ala. 1989)

[211] *Id*. at 1091

[212] *Id.*

are speculative because the taxes were never paid, nor even assessed by the IRS. In *Thomas* the court upheld the defendant's appeal and reversed the damage award.[213]

Similarly, in *Lewin* v. *Miller Wagner & Co. Ltd*.[214] the court reversed as speculative a jury award of damages to the plaintiffs when the jury was permitted to consider expected future taxes to be incurred.[215] In *Lewin* the court did so despite acknowledging that the plaintiffs established the amount of such taxes with reasonable certainty.[216] Also, in *Bronstein* v. *Kalcheim* & *Kalcheim*[217] the court likewise held that no damages were proven in the absence of a Tax Court determination, despite the fact the deduction at issue was disallowed in the course of an IRS audit.[218]

Contrary to the foregoing cases is *Jamison*, *Money*, *Farmer* & *Co*. v. *Standeffer*,[219] and *Oddi* v. *Ayco Corp*.[220] In *Jamison* the court specifically rejected the argument that a jury award for potential additional state taxes that would be incurred in the future was speculative. The court held the expert testimony that the state would also levy taxes against the plaintiff

---

213 *Id.*

214 725 P. 2d 736 (Ariz. App. 1986)

215 *Id*. at 740

216 *Id*. at 741.

217 414 N.E. 2d 96 (Ill. App. 1980)

218 *Id*. at 98.

219 678 So. 2d 1061 (Ala. 1996)

220 947 F. 2d 257 (7th Cir. 1991)

was sufficient to provide a reasonable basis for the award, even if the amount was somewhat uncertain.[221]

In *Oddi,* the defendant investment advisor was negligent in advising the plaintiff to withdraw his retirement account as a lump sum distribution rather than to roll over the amount into an IRA. The amount of damages was inversely related to future tax rates. The higher the future tax rates, the less the damages. The damages could even entirely disappear if the future tax rate increased beyond a certain point.[222] Although cognizant that any prediction of future tax rates was speculative, the Seventh Circuit affirmed the trial court and held that so long as the plaintiff was able to demonstrate that he would sustain injury at the current tax rate, he was deemed to have satisfied his burden of proving damages. The burden of proving the tax rate would change was expressly placed upon the defendant.[223] The Seventh Circuit did so to avoid absolving financial advisors of liability for their erroneous advice. [224]

The difficulty in establishing either future tax rates or the amount that will be subject to tax in the future is especially pronounced in the estate and gift tax/estate planning area. Simply placing the normal burden of proof on the plaintiff to establish damages could easily absolve all estate planners from liability for their mistakes. An excellent example of this is

[221] *Id*. at 1067. *See also* MCNC v. Aon, Consulting, Inc. 2006 WL 3733267 (M.D.N.C. 2006) (voluntary payment to IRS fixes damages despite absence of IRS assessment).

[222] *Supra* note 220, 947 F. 2d at 261.

[223] *Id*. at 261-62. The facts of this case are discussed more fully at text accompanying notes 81-86 *supra.*

[224] *Id*. at 262.

Harmeyer v. *Gustafson*.[225] In *Harmeyer*, the plaintiff and her husband obtained estate planning advice from the defendant attorney. In June 1990 the defendant prepared an irrevocable trust for the plaintiff and her husband. In 1994 the same attorney prepared a deed transferring certain property interests to nieces and nephews.[226] The purpose of these transfers was to remove the transferred assets from the estates of the plaintiff and her husband. Unfortunately, both transfers were defective and did not accomplish their goal. [227] The defects came to light shortly after the death of plaintiff's husband in 1996. However, the defendant escaped liability! With respect to the 1990 transfer, the court held that the statute of limitations commenced to run when the trust documents were signed and therefore barred that cause of action even though plaintiffs never yet had the opportunity to learn there was any problem. [228]

With respect to the 1994 transfer, the action for which was clearly timely under the Minnesota six-year statute of limitations, the court also absolved the defendant from liability, but now, because these damages were too remote and speculative.

[225] 2001 Minn. App. LEXIS 175 (2001). For other cases addressing similar issues, *see generally/* Carlson v. Sweeney, Dabagia, Donoghue, Thorne, Janes & Pagos, ___ N.E.2d ___, 2007 WL 1630413 (Ind. App. 2007); Berg v. Hirschy, 136 P. 3d 1182 (Or. App. 2006).

[226] *Id*. at *1-2.

[227] Each of the transfers were defective under 26 U.S.C. § 2036. The 1990 transfer to the trust retained annual income to the transferors and the 1994 quitclaim deed reserved a life estate for the transferors.

[228] *Id*. at *4 – 7.

> Speculative, remote, or conjectural damages are not recoverable at law …To recover, Harmeyer must prove the fact of loss to a reasonable, although not absolute, certainty. . . .
>
> The district court found that whether estate taxes will have to be paid at Harmeyer's death "will depend on the deductions available under the law to her estate at the time of her death" and that "it would presently be too speculative as to whether or not <u>any</u> damages result based upon the homestead transfer." (Emphasis added.) In other words, any additional tax liability, or damages that Harmeyer's estate might incur will not be determinable until her death. [229]

Other courts have avoided the *Harmeyer* approach basically absolving estate planners from liability in several ways. In *Hosfelt* v. *Miller* [230] the court held that the amount of estate taxes caused by the defendant attorney's failure to advise his client to either disclaim property she would inherit under her recently deceased husband's will or to elect against the will was made definite when the client died at the end of that same year. According to the court, the taxes incurred by her estate were actual damages, despite the fact that attempting to predict those damages while the client was alive may have been speculative. [231]

---

[229] *Id*. at *7 – 8.

[230] 2000 Ohio App. LEXIS 5506

[231] *Id*. at * 14 – 16.

In *Linck* v. *Barokas & Martin* [232] the Alaska Supreme Court seems to have bent over backwards to find there was an adequate allegation of damages – enough at least to withstand a motion to dismiss and allow the plaintiffs to have their day in court. In *Linck*, the defendants, an attorney and accountant, failed to advise the plaintiff about the benefits of a qualified disclaimer. As a result, the widow of the decedent inherited $3 million from her deceased husband. This action brought by the widow and her three children who were the contingent beneficiaries who would have received any property disclaimed by their mother. The trial court dismissed the action, holding the complaint failed to allege any present damages. [233] The Alaska Supreme Court reversed. It held that a valid claim for damages was stated when it was alleged that the widow incurred a present gift tax liability plus attorney and accounting fees in connection with gifts made to the children of property that could have been disclaimed. This, according to the Alaska Supreme Court, stated a claim of actual present damage to the children. [234] The court further held that an allegation in an amended complaint that the widow would have disclaimed a large portion of her deceased husband's estate thereby passing it to the children without payment of gift tax also alleged damages to the children because they would receive less upon the death of their mother due to the imposition of a second estate tax and also because they would have to forego the use of the money until their mother's death. [235]

[232] 667 P. 2d 171 (Ala. 1983)

[233] *Id*. at 173.

[234] *Id*. at 173-74

[235] *Id*. at 174.

In *Williams* v. *Ely* [236] the defendant attorneys erroneously advised the plaintiff that he could disclaim a contingent interest in a trust without incurring gift tax. The advice turned out to be incorrect and gift tax was incurred. In this action for damages against the attorneys, the attorneys attempted to argue that the plaintiff was not harmed because any property subjected to gift tax would subsequently be excluded from his estate and save an equivalent amount of estate tax.[237] In an approach somewhat similar to that of the *Oddi* case [238] the court put the burden of proving the offsetting estate tax savings on the defendant attorneys. The court then held that it was speculative to attempt to predict what the plaintiff would have done with the trust assets had they received, rather than disclaimed, them since they could have spent them, given them away without incurring any gift tax or kept them. [239] Damages were therefore recoverable by the plaintiff.

Rassieur v. *Charles* [240] illustrates speculative damages not involving the prediction of future taxes. In *Rassieur* the defendant accounting firm was hired to prepare a set of books to keep track of the taxpayer's investments and to prepare her tax return for 1940. Due to an error made in recording the taxpayer's cost of certain stock, in November 1940 the accountants informed the taxpayer that she sold the stock at a gain. They further advised the taxpayer to sell other stocks which had declined in value in order to offset the earlier gain with these losses. The taxpayer followed the accountants' advice. In November 1941, the

[236] 668 N.E. 2d 799 (Mass. 1996)

[237] *Id.* at 806

[238] *Supra* note 220.

[239] *Williams, supra,* 668 N.E.2d at 806-07.

[240] 188 S.W. 2d 817 (Mo. 1945)

error was discovered and it turned out that the original stock was sold at a loss, not at a gain. The stocks that were sold for tax losses had appreciated in the intervening year. As a result the taxpayer sued the accountants to recover this difference. The taxpayer also alleged that she was damaged by being deprived of the possibility of being able to sell the loss stocks in some subsequent taxable year when she really would have a capital gain. [241]

With respect to the second claim for damages, for being deprived of the right to sell the stock in the future at a loss, the court held no damages were available since the loss was much too speculative. It depended on the taxpayer having future capital gain, selling these stocks then, these stocks remaining at their current market value and the tax laws remaining unchanged. [242]

Finally, in *Bancroft* v. *Indemnity Insurance Co. of North America*, [243] the doctrine of speculativeness was applied to prevent a defendant accountant from reducing the damages awarded to the plaintiffs. In *Bancroft* the plaintiffs were the principal shareholders in Bancroft Bag Factory, Inc. and Bancroft Paper Company Inc. In May, 1955 the defendant CPA advised them they could sell shares of Paper Company to the Bag Company without incurring any taxes since the shares' value and their basis to the plaintiffs were both $100 per share. The accountant completely overlooked recently enacted IRC section 304 under which

---

[241] *Id*. at 817-18.

[242] *Id*. at 819-20. With respect to the first element of damages claimed by the plaintiff, the court, very perceptively, held that since the taxpayer could have repurchased the loss stocks after 30 days of their sale without violating the wash sales rules, the damages were limited to the difference between the value of the stocks when she could have first repurchased them and what she sold them for. *Id* at 819. The current wash sales rules are at 26 U.S.C. § 1091.

[243] 203 F. Supp. 49 (W.D. La. 1962).

the proceeds received by the plaintiffs would be taxed as a dividend. [244] The plaintiffs sued to recover the total amount paid to the IRS as damages. In an attempt to reduce the damages, the defendants argued that under section 304 the plaintiffs were treated as having contributed their Paper Company stock to the Bag Company, thereby increasing their cost basis in their Bag Company stock. This increase in basis of almost $33,000, the defendants argued, would permit the plaintiffs to receive that much more money on any later sale of their Bag Company shares without incurring any taxes. [245] The defendant argued that their damages should be reduced accordingly. [246]

The court however was not impressed with this argument and refused to reduce the damages awarded because the benefits to the plaintiff were speculative. In addition to noting that the plaintiffs now no longer owned the sold Paper Company shares directly, the court stated: [247]

> [m]oreover, an increased basis or cost, in the capital of the bag factory may be a tax benefit in some years but not in others, depending on the then status of the I.R.C. The future possibilities are too speculative to calculate with any degree of exactness and would depend upon many variables, e.g. the

---

[244] *Id*. at 52

[245] To illustrate, assume the plaintiffs' basis in the Bag Company shares was $40,000 and they sold the shares for $100,000. Now they would have to pay tax on a gain of $60,000 ($100,000 – 40,000). If the plaintiffs' basis in their shares increase by $33,000 to $73,000, their gain on the same sale of these shares for $100,000 is now only $27,000 (100,000 – 73,000) or $33,000 less than before.

[246] 203 F. Supp. at 57.

[247] *Id*.

> current market value of the stock, other income received in the same year by plaintiffs, and whether the stock is subject to estate taxes.

Various types of consequential damages will now be examined.

2. Emotional Distress

The general rule in tax malpractice situations is that no recovery is available for any emotional distress or mental anguish that might result from a tax professional's negligence. [248] The reason for this is usually articulated in one of two ways: either that emotional distress is not a foreseeable result of negligence arising from a purely economic relationship; or that any monetary recovery for the underlying negligence will adequately compensate the aggrieved party.[249] The same result applies even if the underlying cause of action is based in contract, rather than in tort.[250] This result is consistent with the recovery rules for general, non-tax, malpractice by an attorney.[251]

The circumstances under which such type of damage claim may arise are reasonably well illustrated by the few cases on point. The basic potential stress point centers around filing a late or inaccurate return and the need to deal with the ensuing civil audit, which may involve assertions of negligence or civil fraud, IRS collection efforts, and the possibility or actuality of a subsequent criminal prosecution. For instance, in *H&R Block, Inc. v.*

[248] Belt v. Oppenheimer, Blend, Harrison & Tate, Inc, 192 S.W. 3d 780, (Texas 2006); McCulloch v. Price Waterhouse LLP, 971 P.2d 414, 421-22 (Ore. App. 1998); Camenisch v. Superior Court of Contra Costa County, 52 Cal.Rptr. 2d 450,452-56 (Ct. App. 1996); H & R Block Inc. v. Testerman, 338 A.2d 48, 55 (Md. 1975). *See also* Douglas v. Delp, 987 S.W. 2d 879, 884-85 (Texas 1999), and WOLFMAN ET. AL., *supra* note 16, §605.1.2.

[249] *See e. g.* , Belt v. Oppenheimer, *id*, 192 S. W. 3d at 784; Douglas v. Delp, *id*. 987 S. W. 2d at 884, Camenisch v. Superior Court of Contra County, *id.,* 52 Cal. Rptr. at 456 n. 6.

[250] Sorenson v. H & R Block, Inc., 2002 U. S. Dist. LEXIS 18689 at *42-43 (D. Mass. 2002).

[251] *See generally,* MALLEN & SMITH, *supra* note 1 at §20.11.

Testerman,[252] the plaintiffs had the defendant, H&R Block, prepare their tax returns for 1967 and 1968. The plaintiffs had started a service station business in 1967.[253] The returns prepared by H&R Block were so inaccurate, that at trial the plaintiffs' experts characterized the errors as bordering on the absurd.[254] As a result, in addition to being audited, and having to pay back taxes, interest and penalties, the agent recommended criminal prosecution concluding that the tax understatement was deliberate and made with intent to file a false return.[255] Similarly in *Sorenson v. H & R Block, Inc*.,[256] the mental distress was allegedly caused by state and federal audits and from a federal criminal investigation.[257]

Another source or type of emotional distress encountered is illustrated by *Camenisch v. Burns*[258] in which the client learned that his goal of tax avoidance through estate planning was frustrated. The emotional distress allegedly suffered came from having to repair the situation caused by the defendant's negligence, the concern over incurring extra expenses, gift taxes and possibly also extra estate taxes, and the distress of worrying about the financial security of his family upon his death.[259]

---

[252] *Supra* note 248.

[253] *Id.,* 338 A.2d at 49-50.

[254] *Id* at 50.

[255] *Id.*

[256] *Supra* note 250.

[257] *Id.,*2002 U. S. Dist LEXIS 18689 at *42-43. McCulloch v. Price Waterhouse LLP, *supra* note 248 also alleged mental distress from the defendant's failure to file proper and timely returns. *Id*. 971 P. 2d at 421.

[258] *Supra* note 248.

[259] *Id.* 52 Cal. Rptr. 2d at 452.

Although not generally recoverable, in several cases damages for emotional distress were awarded. One of these, *Rhodes v. Batilla*,[260] involved an especially egregious case of attorney malpractice. The plaintiff in this case, Ms. Batilla, was employed as the controller of an office furniture company from 1980 to 1984. She prepared the company books, worked with an outside payroll company to issue payroll checks, and oversaw the purchasing department. She had no authority to sign checks. Starting in 1984, the company experienced financial problems and stopped paying its FICA payroll taxes. After the outside payroll company had quit, whenever Ms. Batilla prepared the payroll, she would always prepare the FICA checks and, in the presence of witnesses, would tender these checks together with the payroll checks to the owner of the company to sign. Invariably, the owner would either refuse to sign the FICA checks or tear them up.[261] In January 1986, Ms. Batilla received a call from an IRS agent who wanted to determine if she was a "responsible person" from whom the FICA payroll taxes could be collected.[262] Ms. Batilla then called the defendant attorney, Rhodes, about representing her in establishing that she was not a "responsible person" liable for the payroll taxes. Rhodes described himself to her as a tax specialist and as an expert with extensive experience with such one hundred percent penalty cases.[263]

---

[260] 848 S.W.2d 833 (Tex App. 1993). The discussion of *Rhodes* is adapted from Malpractice I, *supra note* 2*,* 48 Emory L. J. at 574-6.

[261] *See id.* at 837.

[262] See 26 U.S.C. § 6672(a). Section 6672(a) imposes a penalty of 100% on "[a] ny person required to collect. . . and pay over any tax" who willfully does not. *Id.*

[263] *See Rhodes*, 848 S. W. 2d at 838.

Despite the fact that Ms. Batilla seemed to have a strong case to support her claim that she was not a responsible person,[264] a terrible nightmare ensued caused by defendant Rhodes' misfeasance and nonfeasance. It is almost impossible to summarize Rhodes' misconduct. He ignored the actual facts and submitted a protest containing fictitious, incorrect facts. He neglected to return numerous IRS calls. He appeared at a meeting totally unprepared with any affidavits or case authority that would have been helpful to his client even though he was informed in advance of what he needed for the meeting. He advised Ms. Batilla to obtain a "paper divorce" from her husband to thwart IRS collection efforts. Without informing his client and contrary to her expressed wishes, he signed an IRS form admitting her responsibility for the asserted payroll taxes penalty. Finally, he abruptly resigned from representing Ms. Batilla without even informing her of what he had done. The net result of Rhodes' actions was that Ms. Batilla had to pay the one hundred percent tax penalty, a tax lien was filed against her, and due to the stress of the tax problems and her husband's unhappiness with their "paper divorce," Ms. Batilla's "paper divorce" became a real divorce.[265]

As a result of the defendant's conduct, Ms. Batilla suffered severe emotional distress (in addition to accompanying physical ailments) from "her loss of credit, the destruction of her banking relationships, the emotional trauma of her divorce and the accompanying property loss, and the pain of trying to help her son understand the divorce and where his

[264] *See id.* at 837. A past president of the employer agreed with Ms. Batilla's facts and her conclusion that she was not a "responsible person." *Id.* at 838. She also obtained five affidavits supporting her version of the facts which she sent directly to the IRS in March 1988. *See id.* at 840.

[265] *See id.* at 837-40.

father had gone."[266] Based on the egregious circumstances, the Texas Court of Appeals had no trouble affirming the trail court's award of damages for emotional distress.[267]

Another case in which emotional distress damages were awarded is *Henderson v. Domingue*.[268] In *Henderson* the plaintiff was a plastic surgeon who was also involved in the air charter business. On his 1982 federal income tax return he claimed a deduction for research and development costs incurred in connection with his aviation business. The IRS disallowed the deduction. In 1984 the plaintiff retained the defendant attorney, Domingue, to represent him in his dispute with the IRS. Although Domingue subsequently filed a petition in Tax Court to review the IRS's disallowance of the deduction, the Tax Court suit was later dismissed "apparently due to the inaction on the part of Domingue."[269] Due to the defendant's negligence and his subsequent unavailability to respond to IRS letters demanding payment, a tax lien was placed on plaintiff's property and notice of the lien appeared in the local newspaper.[270] As a result, the plaintiff suffered humiliation, embarrassment and mental anguish. The plaintiff further testified that even at the time of trial he still needed to explain the tax lien in connection with any loan request.[271] Although damages for mental anguish had never before been awarded in Louisiana in a legal malpractice suit,[272] the Louisiana Court of Appeals affirmed the trial court's award of $10,000 for mental distress. The court

[266] *Id.*at 844-45.

[267] *Id.*

[268] 626 So. 2d 555 (La. App. 1993).

[269] *Id.*at 556.

[270] *Id.*at 559.

[271] *Id*

[272] *Id*

based its holding on the defendant's egregious conduct and by analogy to Louisiana law in other tort contexts.[273]

Before leaving this area it should be noted that a number of the cases that hold that no recovery is available for emotional distress contain language suggesting a different result might occur in especially egregious, though unspecified, situations. By analogy to non-tax malpractice, such situations might exist where the plaintiff suffers physical injuries (*i.e*., if the malpractice lands plaintiff in jail),[274] or where the malpractice is intentional or nearly so (*i.e.,* done with malice or reckless disregard).[275]

3. <u>Suicide</u>

In *Cleveland v. Rotman*[276]the Seventh Circuit affirmed a district court's opinion applying Illinois law, and held that suicide is not a foreseeable consequence of bad tax advice. Mr. Cleveland, an attorney, was involved in a fifteen-year tax dispute with the IRS, involving numerous trials and appeals. Mr. Cleveland lost all his assets; the IRS even took Cleveland's social security income in the early 1990's; he was disbarred from practicing law; and he went into debt due to the legal bills, interest, and penalties. As a result, Mr. Cleveland suffered severe depression and became suicidal. In 1996, he retained the defendant-attorney for advice in resolving his dispute with the IRS. The defendant advised Mr. Cleveland to file

---

[273] *Id*

[274] *See e.g.,Testerman, supra* note 248, 338 A.2d at 55; and *Camenisch, supra* note 248, 52 Cal. Rptr. 2d at 453 (citing Holliday v. Jones, 264 Cal. Rptr. 448 (1989)). *See also Sorenson, supra* note 250, 2002 U.S. Dist. LEXIS 18689 at *43 (in Massachusetts in a contractual situation any award for emotional distress damages requires a high showing by plaintiff and typically involves a direct causal link to physical harm), and Wirtz v. Switzer, 586 So. 2d 775, 784 (Miss. 1991).

[275] *See e.g., McCulloch, supra* note 248, 971 P. 2d at 421-22; *Testerman, supra* note 248, 338 A-2d at 55; and Wirtz v. Switzer, *supra* note 274. *See also* WOLFMAN ET. AL., *supra* note 16 at §605.1.2; *Douglas, supra* note 248, 987 S.W. 2d 879 at 884-85.

[276] 297 F. 3d 569 (7th Cir. 2002).

tax returns for a ten-year period. Mr. Cleveland claimed he was unable to calculate his income and expenses for this period because he lost his financial records in office moves and divorce proceedings. The defendant advised him to estimate his income and expenses for those ten years.[277]

As it turned out, Mr. Cleveland's estimates did not match the IRS figures. The IRS decided to audit him again, despite having previously declared his account uncollectible. The audit was originally scheduled for February 1997, but was postponed until January 1998 due to the intervention of Mr. Cleveland's therapist who was concerned over his suicidal tendencies. Mr. Cleveland committed suicide shortly before the rescheduled audit was to take place.[278]

Mr. Cleveland's widow instituted suit on her own behalf and as the executrix of Mr. Cleveland's estate to recover damages due to Mr. Cleveland's suicide. The claim, insofar as it related to the attorney,[279] alleged that the attorney's advice was flawed because he did not obtain the relevant financial information from the IRS, and told Mr. Cleveland to "guess" at the relevant information for the ten years.[280] Seemingly, the plaintiff claimed that the flawed advice caused the IRS audit, which, in turn, caused Mr. Cleveland's suicide.[281]

---

[277] *Id.*at 571.

[278] *Id.*at 571-72.

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

[280] *See* Cleveland v. United States, 2000 U. S. Dist. LEXIS 18908, at *3-4 (N.D. Ill. 2000), *aff'd,* 297 F.3d 569 (7th Cir. 2002). The Seventh Circuit's opinion is not very clear on this point. The district court's opinion is more enlightening.

[281] *See id.* at *4-5.

The Seventh Circuit affirmed the district court's dismissal of the complaint for failing to state a cause of action. [282] The heart of the Seventh Circuit's reasoning was the lack of proximate cause, *i. e.*, that suicide is an independent, intervening event. "[S]uicide is generally not a likely result of bad tax advice, especially when that advice concerns the relatively routine matter of filing tax returns."[283]

As a policy matter, the Seventh Circuit stated that attorneys could not reasonably be expected to screen potential clients for suicidal tendencies. To impose such a burden upon attorneys would expose them to an unreasonable risk of liability.[284]

Interestingly, the district court below and the Seventh Circuit explicitly applied the same rationale to both the plaintiff's tort and contract causes of action.[285]

4. Punitive/Exemplary Damages

Punitive or exemplary damages are designed not to compensate an injured party for loss, but rather are intended to punish wrongful conduct by a defendant. Such damages will be awarded only when a defendant's conduct contains some quantum of culpability, not just mere negligence. Such conduct will likely represent some form of intentional wrongdoing such as where a defendant acts fraudulently or maliciously.[286] While the authorities indicate that punitive damages are generally available in most states in tort actions, and are not generally available in breach of contract actions, they also warn that there are many states

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

[283] *Id*. at 573.

[284] *Id*.

[285] *Id*. at 572.

[286] WOLFMAN ET AL., *supra* note 16, §605.1.3. *See also* 3 MALLEN & SMITH, *supra* note 1, §20.16.

with idiosyncratic rules that vary from the norm.[287] Accordingly, it is especially important to determine the rules of the relevant jurisdiction.

Whether punitive or exemplary damages may be recovered in tax malpractice situations will depend on these same laws of the state that has jurisdiction over the cause of action. There are a number of cases in which punitive or exemplary damages were awarded, or at least considered, in tax malpractice situations. The most interesting juxtaposition involves a pair of cases from the 1970's, *Midwest Supply, Inc. v. H & R Block Co.* [288] and *H & R Block, Inc. v. Testerman*.[289] In each case the defendant, H & R Block, was accused of willfully and wantonly making false and fraudulent misrepresentations as to the tax expertise of its tax return preparers. In each case an incorrect return or returns were prepared and filed as well as amended returns seeking refund of taxes previously paid. In both situations, the plaintiffs were subsequently audited, found to owe substantial additional amounts and were subject to IRS enforced collection procedures.[290] In *Midwest Supply* a punitive damage award of $100,000 was upheld by the Supreme Court of Nevada,[291] while in *Testerman* the Court of Appeals of Maryland held that punitive damages could not be awarded since the tort arose out of a contractual relationship and under Maryland law actual malice -- which was absent here – was a prerequisite to the recovery of punitive damages.[292]

---

[287] *Id*.

[288] 510 P.2d 876 (Nev. 1973)

[289] 338 A.2d 48 (Md. 1975), *overruled by* Owens-Illinois, Inc. v. Zenobia, 601 A.2d 633 (Md. 1992).

[290] *Midwest, supra,* 510 P.2d at 877-78; *Testerman, supra,* 338 A.2d at 49-50.

[291] 510 P. 2d at 879.

[292] 338 A.2d at 54-55.

In *Rhodes v. Batilla*[293] the Texas Court of Appeals easily affirmed an award of $125,000 in exemplary damages in addition to compensatory damages of $125,500. As indicated previously in the discussion of recovery for mental distress,[294] the defendant attorney's misdeeds were so numerous and so egregious, that the result is most appropriate. Punitive damages were also awarded in *Jerry Clark Equipment, Inc. v. Hibbits,*[295] where the defendant, who was an attorney and CPA, inexplicably failed to prepare and file the plaintiff's corporate income tax returns for three years, and *Yarbrough v. Cooper,*[296] in which the defendant attorney agreed to find the plaintiff a tax shelter to take care of his tax problem and failed to do so despite reassuring the plaintiff several times that he had his solution.

Deloitte & Touche v. Weller,[297] was a class action brought by limited partner investors in a tax shelter partnership against the partnership's accountant for negligence in the preparation of the partnership's tax return. The alleged negligence was that the accountant failed to confirm that a substantial expense claimed by the partnership had in fact been incurred.[298] The trial court awarded exemplary damages exceeding $77.6 million in addition to compensatory damages of over $79 million.[299] However, the award was reversed on appeal and the claim dismissed on statute of limitations grounds.[300]

---

[293] 848 S.W. 2d 833 (Tex. App 1993)

[294] *See* text accompanying notes 261-67, *supra*.

[295] 612 N.E.2d 858 (Ill. App. 1993).

[296] 559 S.W.2d 917 (Tex. App. 1977).

[297] 1998 WL 188712 (Tex. App. 1998).

[298] *Id*. at *1-2.

[299] *Id*. at *2.

[300] *Id*. at *9.

Instructions on punitive damages were submitted to the jury in both *King v. Neal*[301] and *Baker v. Bennett*,[302] though in each case the jury did not award any.[303]

5. Attorney Fees

The recoverability of attorney fees incurred by a plaintiff as damages in a tax malpractice situation depends upon the nature and type of attorney fees involved. Where the attorney fees are incurred to correct, or attempt to correct, the damages flowing from the defendant's negligence, these are corrective costs and are certainly recoverable as core damages, as previously discussed.[304]

Contrary to corrective attorney fees are the attorney fees incurred to prosecute the malpractice action against the negligent tax advisor. Such malpractice litigation fees, under the so-called American Rule, generally are not recoverable as damages.[305] The rationale for this rule is "since litigation is at best uncertain one should not be penalized for merely defending or prosecuting a lawsuit, and that the poor might be unjustly discouraged from instituting actions to vindicate their rights if the penalty for losing included the fees of their

---

[301] 19 P. 3d 899 (Okla. App. 2001).

[302] 603 So. 2d 928 (Ala. 1992).

[303] *See also* Porter v. Odgen, Newell & Welch, 241 F.3d 1334 (11th Cir. 2001) in which the Eleventh Circuit affirmed an order of the trial court granting the plaintiff discovery of the defendants' financial worth documents, thereby enabling a later claim for punitive damages. *Id*. at 1340-41.

[304] *See supra* Part III.A4.

[305] *See*, *e.g.*, John Kohl & Co. v. Dearborn & Ewing, 1997 WL 195469 at *7 (Tenn. App.); Lewin v. Miller Wagner & Co., Ltd., 725 P. 2d 736, 743-44 (Ariz, 1986); Whitney v. Buttrick, 376 N.W. 2d 274, 281 (Minn. 1986); Sorenson v. Fio Rito, 413 N.E. 2d 47, 51-52 (Ill. App. 1980); Slaughter v. Roddie, 249 So. 2d 584, 586 (La. App. 1971). *See generally* 3 MALLEN & SMITH, *supra* note 1 at § 20:14; WOLFMAN ET AL., *supra* note 16, § 605.1.1 at p. 502; Restatement of Torts 2d § 914 (1979).

opponents' counsel."[306] While this is the general rule, there are statutory or common law exceptions in particular jurisdictions which may permit the recovery of such fees.[307] It should be noted that a different result may occur depending on whether the cause of action is framed in tort or in contract.[308]

Another type of attorney fees, which could just as easily also be accountant (or some other professional's) fees, are the initial fees agreed to be paid for the services that ultimately were performed negligently. The issue is whether such initial fees should reduce the amount of a plaintiff's tax malpractice recovery? To illustrate, assume that an attorney or accountant is retained to obtain a refund of the $50,000 tax overpayment made by the plaintiff. For this work, the plaintiff agreed to pay the attorney or accountant a fee of $10,000. If the overpayment cannot be obtained due to the defendant's negligence (*i.e.*, missing a statute of limitations), are the recoverable damages $50,000, the full gross amount of the overpayment, or are they only $40,000 the overpayment reduced by the fee. The logic for treating the recoverable damages as $40,000 is obviously that this is the net amount the plaintiff had ever intended to obtain and keep.

According to the Wolfman treatise, *Standards of Tax Practice*,[309] the courts are split on this issue. While some courts do reduce the award to reflect the actual injury suffered by

---

[306] Fleischmann Distilling Corp. v. Maier Brewing Co., 386 U.S. 714, 718 (1967).

[307] *See e.g.*, Sorenson v. H & R Block, Inc., 2002 U.S. Dist. Lexis 18689 at *62 (D. Mass) (Mass. Deceptive Trade Practices Act, Mass. Gen. Laws ch. 93A, § 9(4)); Pytka v. Gadsby Hannah, LL.P., 2002 Mass. Super. LEXIS 461 At *26-27 (Mass. – same as in *Sorenson*); Deloitte, Haskins & Sells v. Green, 403 S.E 2d 818, 821-22 (Ga. 1991) (OCGA § 13-6-11); Lewin v. Miller Wagner & Co. Ltd., *supra* n. 305 (A.R.S. § 12-341.01 (A) *See generally* 3 MALLEN & SMITH, *supra* note 1 § 20.14 at p.46-48.

[308] *See e.g.*, Lewin v. Miller Wagner & Co. Ltd., supra n.305. See generally 3 MALLEN & SMITh, *supra* note 1, § 20.14 at 45-46.

[309] WOLFMAN ET. AL. *supra* note 16, § 605.1.4.

the plaintiffs, other courts have refused to do so. The reason of the latter courts is that since the legal fees paid to prosecute the malpractice action are not recoverable under the American Rule, such fees effectively offset the initial fees that the plaintiff intended to pay for proper performance by the defendant.[310] Mallen and Smith in their treatise, *Legal Malpractice*,[311] which is not limited to just tax malpractice, conclude that not reducing damages by the initial attorney fees is now the majority view of the decisions that have discussed the issue.[312] Interestingly, of the five cases cited as authority by Professor Wolfman, none involve tax malpractice[313]

This same issue seems to be implicated whenever a plaintiff seeks recovery of the initial fee paid the defendant as part of the damage award in a malpractice litigation. Several tax malpractice cases have addressed this issue. In both *King* v. *Neal*[314] and *Slaughter* v. *Roddie*[315] the damages awarded the plaintiff included recovery of the initial fee paid the respective return preparer.[316] In *Pytka* v. *Gadsby Hannah, LL.P.*,[317] the damage award included the attorney fees paid for the deficient legal work provided by the defendant law

---

[310] *Id. See also* John Kohl & Co., P.C. v. Dearborn & Ewing, *supra* n. 305, 1997 WL 195469 at *5-6.

[311] *Supra* note 1.

[312] *Id*. § 20.18 at p. 57-58.

[313] See WOLFMAN ET. AL. *supra* n. 309 at nn. 26-27.

[314] 19 P. 3d 899 (Okla. App. 2001).

[315] *Supra,*note 305.

[316] In *King* it was the fee for the preparation of the 1991 tax return, 19 P. 3d at 900; in *Slaughter* it was the fee for claiming an erroneous loss carryback, 249 So. 2d at 585-86.

[317] *Supra* note 307.

firm.[318] *John Kohl & Co., P.C.* v. *Dearborn & Ewing*[319] likewise permitted recovery of the initial attorney fees paid for the deficient legal advice, but the court was more attuned to the fine points. It insisted that the defendants receive credit for those expenses incurred on behalf of plaintiffs which ultimately benefited the plaintiffs.[320] Note should also be taken of *Orsini* v. *Bratte*n[321] which involved negligence by an investment advisor. The defendant investment advisor convinced the plaintiff to purchase a hotel property and lease it back to the seller. The advice was flawed, incorrectly assuming the availability of a number of tax benefits, including an investment tax credit, that were not actually available. The defendant investment advisor also prepared the plaintiff's tax return for 1977, the year the investment was made, and amended tax returns for 1974 and 1975 to claim a carryback credit in these years.[322] Among the damages awarded by the trial court was a refund of the fees paid by the plaintiff to the defendant. On appeal, the defendant did not dispute this portion of the damages awarded, though he did vigorously dispute other elements of the award.[323] Presumably, all these courts follow the "majority" view of awarding the gross amount of damages claimed, not reduced by initial attorney (or other) fees.

---

[318] *Pytka* involved malpractice by an "of counsel" at the defendant law firm who turned out not to be admitted to practice anywhere in the United States. 2002 Mass. Super LEXIS 461 at *3. However, the court's analysis by and large treated him as if he were an attorney, as implicitly represented by the defendant.

[319] *Supra* note 305.

[320] *Id.*, 1997 WL 195469 at *6.

[321] 713 P. 2d 791 (Alaska 1986).

[322] *Id*. at 792.

[323] *Id.* at 793.

Contrary to the above cases is *Lewin* v. *Miller Wagner & Co. Ltd*.[324] *Lewin* involved a tax malpractice claim against an accountant. The lower court, pursuant to a jury verdict, awarded $200,000 in damages to the plaintiff and also awarded the defendant accountant $4,500 on his counterclaim for unpaid fees. On appeal, the award to the plaintiff was reversed and remanded for a new trial because the original damage request to the jury contained an impermissible request for future damages the appellate court found to be speculative.[325] Nevertheless, the award of accounting fees to the defendant was upheld.[326] Presumably, *Lewin* belongs to the minority view that would reduce the full, gross amount of damages by the amount of the initial fee.

6. Miscellaneous

In this section brief note will be made of various types of damage claims that have arisen in the reported cases, and some others that could easily arise. It should be emphasized that the fact that a claim was asserted does not mean there is a definite adjudication as to whether it is allowable. Often, a number of such claims are asserted and there is a general monetary award by either the jury or the judge, or disposition of the case on other grounds, and it is impossible to determine whether such claim resulted in any recovery. For instance in *King* v. *Neal,*[327] the plaintiffs testified "that the timing of the additional taxes, interest, and penalties produced an added financial burden that contributed to their filing bankruptcy."[328]

---

[324] *Supra* 305.

[325] *Id*. at 741.

[326] *Id*. at 744

[327] 19 P. 3d 899 (Okla. App. 2001).

[328] *Id*. at 902

However, there is no indication that the jury awarded any damages for this claim.[329] Similarly, in *Avakian* v. *Ohanessian*[330] there was the rather novel claim that the erroneous tax return prepared by the defendant accountant caused the plaintiff's partner to dissolve their partnership.[331] *Avakia*n, however, never focused on this issue, but affirmed the summary judgment granted the defendant dismissing the suit on statute of limitations grounds.[332]

In several cases the plaintiffs sought to recover the interest incurred when they had to borrow the money used to pay the excessive tax bill caused by the defendant's negligence.[333] There have also been several variations on this claim. In *Hall* v. *Gill,*[334] when the plaintiffs were unsuccessful in their attempts to borrow money to pay the unexpected IRS assessment, they took money from the husband's teachers' retirement fund thereby incurring substantial penalties and interest.[335] In *Brackett* v. *H.R. Block & Co*.,[336] the plaintiff alleged that the

---

[329] *Id.*

[330] 2002 Cal. App. Unpub. LEXIS 9275 (Cal, App. 2002)

[331] *Id*. at *13.

[332] *Id*. at *1.

[333] *See e.g.*, Wynn v. Estate of Holmes, 815 P. 2d 1231, 1235 (Okla. App. 1991), *overruled by* Stroud v. Arthur Anderson*, 37 P.3d 783, (Okla. 2001);* Lewin v. Miller Wagner & Co., Ltd., 725 P. 2d 736, 739 (Ariz. App. 1986); Warmbrodt v. Blanchard, 692 P. 2d 1282, 1284 (Ariz. 1984). In *Wynn*, the Oklahoma Court of Appeals stated that the reason the trial court awarded the plaintiffs pre-judgment interest was because they needed to borrow money to pay the tax deficiency. Id., 815 P. 2d at 1235.

[334] 670 N.E. 2d 503 (Ohio App. 1995).

[335] *Id*. at 505-06.

[336] 166 S.E. 2d 369 (Ga. App. 1969)

negligent tax return prepared by the defendant for her so vastly overstated her tax bill "that she was forced to sell her other property in order to pay it".[337]

If a taxpayer is unable to pay the tax disclosed on a tax return, the IRS can be expected to eventually commence enforced collection activities such as filing liens, levying on property, garnishing wages, etc. and filing any required related notices.[338] Any of these actions could easily have a detrimental effect on a taxpayer's ability to borrow for personal and/or business needs, could destroy credit ratings, destroy banking relationships etc.[339] Such results could easily generate damages that might be recoverable. However, proving the existence and precise amount of such damages might be a hurdle difficult or impossible to overcome. In both *Henderson* v. *Domingue*[340] and *Rhodes* v. *Batilla*[341] the existence of this type of injury, together with egregious conduct by the defendant, resulted in the award of damages for emotional distress.

A rather unique award of interest damages occurred in *Billings Clinic* v. *Peat Marwick Main & Co*.[342] Here, the plaintiff, Billings Clinic, was a partnership consisting of medical doctors who were operating a medical clinic. During 1981 and 1982, Billings was involved in two projects simultaneously: it was reorganizing its ownership in several

---

[337] *Id*. at 371

[338] *See generally* IRC Cha. 64, §6301 *et. seq*.

[339] *See e.g*. Henderson v. Domingue, 626 So. 2d 555, 559 (La. App. 1994); Rhodes v. Batilla, 848 S.W. 2d 833, 844-45 (Tex. App. 1993).

[340] *Id*.

[341] *Id.*

[342] 797 P. 2d 899 (Mont. 1990).

corporations that owned clinic-related real estate and it was seeking to renovate and expand its clinic facilities. The expansion of the clinic was to be financed with industrial development bonds.[343] Industrial development revenue bonds are a very cheap method of financing because the bonds generate tax-free interest to the creditor.[344] The defendant accounting firm was involved to some degree in each project.[345] It later turned out that Billings was unable to qualify to issue the industrial development revenue bonds because of the prior reorganization of its real estate holdings. Billings subsequently obtained conventional financing for its new construction, but at a substantially higher cost.[346] It then brought this suit for malpractice based on defendant's failure to inform Billings that the reorganization would prevent the issuance of the industrial development revenue bonds. The damages awarded Billings were the difference in financing cost between the conventional financing obtained and what the cost would have been utilizing the industrial development revenue bonds.[347]

While the accounting firm in *Billings Clinic* was held liable for rather novel damages, the defendant, an attorney and his law firm, escaped liability on statute of limitations grounds in *Spencer* v. *Sommer*.[348] In *Spencer* the defendant attorney was the co-personal

---

[343] *See id*. at 901-02

[344] *See generally* 26 U.S.C. § 103

[345] 797 P. 2d at 902-04.

[346] Id. at 903.

[347] *Id*. at 911-12.

[348] 2004 U.S. App. LEXIS 218 (10th Cir. 2004)

representative of the plaintiff's father's estate and his law firm was counsel to the estate.[349] Two years before his death, the plaintiff's father entered into a contract to sell land to an individual who was also defendant's client. Due to various complications, at the time of the father's death, the contract had not been consummated, nor had the buyer agreed to an extension he was offered. The damages to the plaintiff were allegedly caused when the defendant attorney incorrectly advised the plaintiff that the contract was enforceable by the buyer, and if enforced, would result in dire income tax consequences.[350] As a result of the advice, the plaintiff entered into a new contract with the same buyer on less favorable terms, rather than seek a new buyer.[351]

In two cases plaintiffs unsuccessfully attempted to recover damages for the value of the time they expended in correcting the situation caused by the defendant's negligent tax advice.[352]

A claim for relatively unusual type of damages is encountered, in *Deloitte, Haskins & Sells* v. *Green.*[353] In *Deloitte*, the plaintiff successfully sued his accounting firm for incurring over $650,000 in unanticipated taxes upon the sale of his business. In addition to seeking

---

[349] *Id*. at *2.

[350] *Id*. at *7. The dire income tax consequences involved income in respect of a decedent. *See generally* 26 U.S.C. § 691.

[351] *Id*. at *7-8.

[352] J.D. Warehouse v. Lutz & Co., 639 N.W. 2d 88 (Neb. 2002): Streber v. Hunter, 221 F.3d 701 (5th Cir. 2000). In *J.D. Warehouse* a claim for such damages was asserted but the trial court did not award any damages on these claims. 639 N.W. 2d at 92. In *Streber* the trial court had decided not to submit this claim for damages to the jury, but by error it was nevertheless included in the verdict form and the jury awarded $97,500. This portion of the jury award was vacated by the Fifth Circuit. 221 F.3d at 734.

[353] 403 S.E. 2d 818 (Ga. App. 1991).

compensation for the unexpected taxes, interest and penalties, the plaintiff also sought compensation for the termination bonuses ($264,000) paid to employees in connection with the sale and for $800,000 in salary he would have earned had he not sold the business based on defendant's negligent advice.[354] While there is no indication in the opinion whether the jury awarded any amount on these claims, it appears likely that no such award was made. This is based on the fact that the amount awarded by the jury was very close to the amount of additional taxes claimed to have been incurred by the plaintiff.[355]

The amount of money lost on bad investments was recovered in *Harrell* v. *Crystal.*[356] In *Harrell* the plaintiffs were of very modest means. In 1975 they won approximately $476,000 in the Irish sweepstakes. They did not know how to deal with so much money and sought the defendant, Crystal's, advice. They repeatedly informed Crystal that their primary goal was financial security.[357] Despite leading them to believe that he would only recommend some type of no-risk tax shelter, he had the plaintiffs invest in three very high risk shelters.[358] All three shelters were unsuccessful – and so unsuccessful that they lost most of their $100,000 investment in addition to not obtaining any of the anticipated tax benefits.[359] Here the damages awarded plaintiffs included repayment of their lost investments.[360]

---

[354] *Id*. at 819.

[355] The plaintiff claimed to have paid $653,200 in unanticipated taxes, while the jury's verdict was for $625,224. *Id*. at 819. The jury also separately awarded attorney fees that were permitted under local law. *Id*.
[356] 611 N.E. 2d 908 (Ohio App. 1992)

[357] *Id*. at 910.

[358] *Id*. at 910-11.

[359] *Id*. at 911-12

One additional type of consequential damages needs to be mentioned here, though discussion will be deferred to the next part of this article. Those damages occur when an audit is triggered by the negligent tax advice and the audit uncovers other, unrelated, tax deficiencies. Although, in a very real and practical sense such damages flow from the negligence of the tax advisor, whether they are recoverable raises some interesting policy issues.

IV Other Damages Issues

Now that a rather detailed examination of various specific elements of damages has been completed, this portion of the article will focus on several conceptual issues. While most of the issues examined go well beyond any one specific item of damages, the first issue -- audit damages -- arguably is much narrower in scope. However, since it involves a significant public policy concern, it is included here rather than in the previous portion of the article.

A. Audit Damages

An intriguing issue from a public policy standpoint is whether audit damages can or should be recoverable in a tax malpractice situation. "Audit damages" is meant to refer to

---

[360] *Id*. at 913-14. It should be noted that damages were also awarded for a bad tax shelter investment in Baker v. Bennett, 603 So. 2d 928 (Ala. 1992). However, in *Baker* the malpractice claim against the defendant was dismissed by a directed verdict and the award was only for a fraud-type claim. *Id*. at 930-31. Also, in *Baker*, the precise nature of the award, other than that it was compensatory and not punitive, was unclear. *Id*. at 931.

tax deficiencies not related directly to the negligent tax advice, but which are discovered as a result of an audit caused by the negligent tax advice. To illustrate, assume a tax advisor erroneously deducts a rather obvious capital loss of $10,000 as an ordinary loss on the tax return of an individual taxpayer. Upon audit, the agent discovers that the taxpayer has erroneously deducted $20,000 of business expenses and disallows that deduction. Are the additional taxes triggered by the disallowance of the $20,000 of business expenses recoverable from the negligent return preparer? What if the taxpayer has been claiming a deduction for the same type of business expenses every year for the past ten years and has never been audited, nor have the deductions ever been challenged until this year?

From a pragmatic standpoint, the return preparer's negligence has caused this extra tax to be incurred. But for the erroneous treatment of the capital loss, presumably the taxpayer could have continued on his merry way, unchallenged in his deduction of these business expenses. It is certainly foreseeable that once an audit is triggered, other deficiencies on the tax return are likely to be discovered. Presumably there is also proximate causation.

On the other hand, from a public policy standpoint it is difficult, if not impossible, to imagine that a taxpayer has the right to misreport deductions or income on a tax return and has the further right to be free from a tax audit. In addition, while it is likely that the error of the negligent return preparer in misreporting the capital loss as an ordinary loss triggered the tax audit, is it ever possible to be absolutely certain? Perhaps the IRS finally has caught up with this taxpayer. Perhaps, she or he would in any event have been audited this year.

In response to my earlier articles on tax malpractice I received a number of phone calls and e-mails from practitioners desiring to discuss their particular situation. In several of these situations, audit damages were a significant issue. Unfortunately, none of these cases seem to have resulted in a reported opinion. Of all the tax malpractice cases I have reviewed over the years, there seems to be only one reported case which probably involved audit damages, but the case did not highlight the issue as such. That case is *Slaughter* v. *Roddie.*[361]

In *Slaughter*, the taxpayer Mr. Slaughter, sued his return preparer for damages incurred for the wrongful preparation of Mr. Slaughter's 1964 income tax return. Mr. Slaughter was in the air conditioning business. At the defendant's suggestion he agreed to file a loss carryback on his 1964 tax return. Several months later he received a refund from the IRS for approximately $1502 plus interest of $32. Several months later Mr. Slaughter received notification that he would be audited. As the ultimate result of the audit, Mr. Slaughter had to repay the IRS the refund and interest he received, plus a penalty of $76.74 and interest on the rebate of $166.36. In addition, he also had to pay a penalty of $135.05 for failing to file a Form 941 plus interest of $53.19 for this failure.[362] The latter two items seem clearly to be audit damages since failing to file a Form 941, which is a form used by employers to report wages paid to employees, has nothing to do with an erroneous loss carryback. At trial, Mr. Slaughter specifically was not allowed any recovery for the Form 941 penalty and interest.[363] On appeal the Louisiana Appellate Court held:[364]

---

[361] 249 So. 2d 584 (La. App. 1971).

[362] *Id*. at 585.

[363] *Id*. at 585-86.

[364] *Id.* at 586.

> [w]e are of the opinion, as was the trial court, that the penalty assessed for failure to file a Form 941 in the sum of $135.05, and interest thereon was properly disallowed. Plaintiff failed to prove this portion of his claim for damages, and his attorney admitted in his appellate brief that this would have been due notwithstanding the erroneous advice given by defendant.

While it is interesting to speculate whether the court would have reached the same conclusion in the absence of the admission by plaintiff's attorney, the bottom line is that no recovery was permitted for these audit damages.

Although there is virtually no authority apart from *Slaughter* of which I am aware, I believe that as a matter of public policy audit damages generally should not be recoverable. Allowing their recovery would seem to endorse the notion that taxpayers have the legal right to play the audit lottery, an unacceptable concept.

B. Timing Tax Benefits

In the discussion in Part III above of additional taxes incurred by a plaintiff as an element of core damages,[365] no distinction was made between permanent tax benefits and timing tax benefits. The primary reason for this is because the overwhelming majority of

[365] See part IIIA.1. *supra*

cases never even mention this distinction, much less focus upon it. The purpose of this section is to superimpose a layer of refinement on the concept of tax damages, especially with regard to timing tax benefits. The primary reasons for doing so are twofold: first, some of the case do occasionally, and appropriately, raise the issue;[366] and second, approximately ten years ago a commentator concluded that no recovery ought to be available for timing tax benefits[367] and I wish to refute that conclusion.

As the name implies, permanent tax benefits are those that benefit a taxpayer outright and permanently. For instance, obtaining a tax credit,[368] qualifying for the exclusion from tax on the sale of a personal residence,[369] or qualifying for the lower tax rate on long term capital gain[370] all reduce a taxpayer's tax. Timing tax benefits do not reduce a taxpayer's tax permanently. Instead, they really only defer the tax to some future time. This deferral is, of course, economically valuably due to the time value of money,[371] but, if viewed over its entire lifetime, there is no actual tax reduction.[372] Examples of such timing tax benefits would include the following "tax free" transactions: an exchange of property held for

---

[366] *See e.g.*, J.D. Warehouse v. Lutz & Co., 639 N.W. 2d 88 (Neb. 2002) (defendant argued timing damages are not recoverable); Baker v. Bennett, 603 So. 2d 928 (Ala. 1992) (defendant argued shelter transaction was a deferral, not a deduction. *Id.* at 936).

[367] Jeffrey A. Rich, Financial Professionals' Liability To Clients for Lost Tax Benefits, 80 TAX NOTES 217 (7/31/98). (Hereinafter "Rich".)

[368] *See e.g.* I.R.C. § 21 *et. seq*., 26 U.S.C. § 21 *et. seq*.

[369] I.R.C. § 121, 26 U.S.C. § 121.

[370] I.R.C. § 1(h), 26 U.S.C. § 1(h).

[371] *See e.g.*, Burdett v. Miller, 957 F. 2d 1375, 1384 (7th Cir. 1992).

[372] The statement in the text assumes there are no changes in the tax rate or in the taxpayer's tax bracket. Regardless of these, barring a change in the substantive law, the total amount subject to tax will be the same, though in the future rather than presently.

productive use in a trade or business for like kind property,[373] the replacement of involuntarily converted property with similar property,[374] the transfer of property to a controlled corporation for stock in the corporation,[375] and the transfer of property to a partnership in exchange for an interest in the partnership.[376] Similarly, being able to immediately deduct the cost of business property rather than being required to depreciate it over a period of years is a timing tax benefit.[377]

To illustrate the operation of a timing tax benefit, assume investment real estate having a value of $500,000 and a basis of $100,000 is exchanged "tax free" for like kind property under IRC section 1031. Although there is gain of $400,000 (i.e., 500,000 – 100,000) inherent in this property, pursuant to section 1031 the gain will not be recognized on the exchange. However, under the basis rules,[378] the taxpayer's tax basis in the new property will be same $100,000 as in the old property. The $400,000 gain not recognized on the exchange has been preserved in the new property, which is now worth $500,000 but has a tax basis of only $100,000. It will be recognized when the new property is disposed of in a taxable transaction.[379] In contrast, if the investment real estate had been sold for cash in a

---

[373] I.R.C. § 1031, 26 U.S.C. § 1031.

[374] I.R.C. § 1033, 26 U.S.C. § 1033.

[375] I.R.C. § 351, 26 U.S.C. § 351.

[376] I.R.C. § 721, 26 U.S.C. § 721.

[377] Compare I.R.C. § § 179 and 168; 26 U.S.C. § § 179 & 168.

[378] IRC § 1031 (d), 26 U.S.C. § 1031(d)

[379] It is possible to circumvent the operation of the deferral mechanism, but it is intended to operate generally as described in the text. One way to circumvent this operation would be to hold the new property until death. The heir would then get a "stepped-up" (i.e., fair market value at death) basis under IRC § 1014, 26 U.S.C. § 1014

taxable transaction, and the new property purchased for cash, gain of $400,000 would be recognized on the sale and the tax basis in the new property would have been its full value, its cost of $500,000.

While normally a tax timing difference refers to a "tax free" or "non-recognition" situation in which an immediate tax is avoided and the tax is deferred to the future through special basis rules, there are a number of instances in the IRC involving the opposite situation. That is where an immediate tax, or harsher tax treatment, is incurred now and an offsetting favorable basis adjustment is available for the future. Examples of this would include a redemption of shares of stock in a corporation which is taxed as a dividend under IRC section 302[380] and a sale of stock in one corporation to a related corporation which is taxed as a dividend under IRC section 304.[381] In both of these situations the basis in the transferred shares that is now ignored is available to reduce gain that will be recognized in the future.[382] As will be immediately evident, either of these situations can be involved in tax malpractice litigation.

The two cases that have directly addressed timing tax benefits seem to have reached the correct conclusion that the loss of such benefits are recoverable as damages from the negligent tax professional, though one of the cases may not have actually applied the

---

and the deferred gain will never have been taxed. It is similarly possible to hold the old property until death and avoid subjecting any gain to tax.

[380] 26 U.S.C. § 302.

[381] 26 U.S.C. § 304.

[382] See Treas. Reg. § 1.302-2(c) and I.R.C. § 304 (a)(1) (last sentence).

principle to its facts. *Bancroft* v. *Indemnity Insurance Co. of N.A.*[383] which was previously discussed,[384] seems to have gotten the analysis completely correct. In *Bancroft* the defendant accountant advised the plaintiffs they could sell shares of stock in one of their corporations to another corporation they owned and that no tax would be incurred because the selling price and the basis of the shares were each $100 per share. This advice was given in May, 1955. The accountant, unfortunately, had overlooked the then new IRC section 304, under which such a sale of stock to a related corporation was taxed as a dividend of the full sales price received.[385] The plaintiff received as damages the full amount of additional taxes (plus interest) paid to the IRS. In an attempt to reduce the damages, the defendant argued that the plaintiff was not injured by the full additional amount paid now to the IRS, but that this amount should be reduced by virtue of the fact that under the basis rules of IRC section 304, the plaintiff's basis in the purchasing corporation's shares was increased by almost $33,000 and this would result in a future tax benefit to the plaintiff. In effect, the defendant was making a timing tax benefit argument – that some of the present tax would be offset by a future benefit and was not permanent.[386] As indicated previously, the court held that the existence of such future tax benefit was too speculative to calculate and could not be considered to reduce the plaintiff's damages.[387]

---

[383]203 F. Supp. 49 (W.D. La. 1962).

[384] See text accompanying notes 243-46, *supra*

[385] 203 F. Supp. at 52.

[386] This involved the second type of deferral situation mentioned above, rather than the more typical non-recognition type.

[387]203 F. Supp. at 57.

J.D. Warehouse v. *Lutz & Co*.[388] involves almost a paradigm timing tax benefit case. In *J.D. Warehouse* a partnership, under threat of condemnation, sold a warehouse for $3.15 million in May, 1988, resulting in a realized gain of over $2.44 million. In 1989, the partners consulted with the defendant accountant concerning the requirements for gain deferral under IRC § 1033. The accountant erroneously advised them that the entire gain could be deferred if they purchased suitable replacement property for an amount equal to the $2.44 million gain on the sale. Relying on this advice they timely purchased suitable replacement property costing $2.5 million. In actuality, to defer taxation of their entire gain, they needed to spend the full $3.5 million sales proceeds on the replacement property. The error was caught in 1992 by the IRS during an audit of the 1988 tax return, resulting in additional tax and interest, but no penalties, imposed on over $520,000 of capital gains.[389] The partnership and the individual partners filed suit against the accountant and his firm for malpractice. The plaintiffs sought to recover the additional federal and state taxes and interest as well as certain other elements of damages.[390]

The trial court had no difficulty in finding the defendants liable. The court found the error by the accountant clearly fell below the standard of care applicable to accountants in the area and that the plaintiffs had relied on the accountant's advice. The only remaining issue requiring analysis was determination of damages.[391]

---

[388] 639 N.W. 2d 88 (Neb. 2002).

[389] *Id*. at 90-91. Portions of the textual discussion of the *J.D. Warehouse* case are from Malpractice II, *supra* note 2, 78 St. John's L. Rev. at 1086-88.

[390] *Id*. at 91.

[391] *Id*.

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

Although, the trial court's statement of the principle involved seems correct, it then did something bizarre. The trial court then went on to hold that the defendant's advice was not the "legal cause" of the additional taxes. The trial court reasoned that the plaintiffs incurred the tax liability in May, 1988 when they sold the warehouse. Since utilization of § 1033 merely defers, but does not eliminate, the tax liability, the court concluded that the accountant's erroneous advice given in 1989 did not create the plaintiff's tax liability. Therefore, because the defendants were not the "legal cause" of the additional taxes, no damages were recoverable.[392] The trial court's opinion, failed to consider the critical point that the accountant was specifically retained to obtain § 1033 treatment and that, but for his negligence, no tax would have been owed for 1988. This brings the analysis back to determining the value of the ability to defer taxes, which the trial court had just endorsed as recoverable in principle but did not apply.

---

[392] *Id*. at 91-92.

On appeal to the Nebraska Supreme Court the plaintiffs again sought to recover the additional taxes, interest and certain other elements of damages. The defendant, in a cross-appeal contended "that the district court erred in failing to find as a matter of law that the proof of damages resulting from the loss of a right to defer income is necessarily too uncertain and speculative to serve as the basis for any recovery."[393]

The Nebraska Supreme Court, however, sidestepped the issue. The court first reiterated some basic and noncontroversial principles, for instance, noting that the purpose of damages is to place the injured party in the same position, as far as money can do, as the party would have been in had there been no injury. The Court also pointed out that while damages need not be established by the plaintiff with mathematical certainty, damages cannot be established by speculative or conjectural evidence.[394] As to the present case, the Court held there was insufficient evidence before the trial court to establish the amount of the tax damages. The problem was that the case was tried based on fully stipulated facts. While the stipulation indicated that additional capital gain of over $520,000 was found by the IRS, and that additional taxes and interest were actually paid by each partner,[395] the amounts of such payments by the partners were never indicated in the stipulation.[396]

---

[393] *Id*. at 92.

[394] *Id*. at 92-93.

[395] In partnership taxation, the partnership is a pass-through entity that files a tax return but does not pay tax. Tax is paid by each partner on his/her ratable share of partnership income and deductions. *See* IRC § 701, 26 U.S.C. § 701.

[396] 639 N.W. 2d at 93-94.

Alas! What could have been a truly groundbreaking opinion in this area of tax-deferral damages was not to be – though the trial court did state the principle correctly.[397]

Montes v. *Asher & Co*.[398] is another case involving a paradigm timing situation, but here too the court did not reach the damages issue. In *Montes* the plaintiffs owned a McDonald's restaurant which they sold back to the company. In connection with the transaction they sought assistance and advice from the defendant accountant. Their discussions with the accountant included the possibility of their purchasing another restaurant. The accountant never discussed with plaintiffs the possibility of avoiding tax on the disposition of their restaurant by exchanging it for another restaurant (like-kind property) under IRC § 1031, rather than selling it and purchasing a new one.[399]

The court in *Montes* granted the plaintiffs' motion for summary judgment on the liability issue, holding the failure to discuss the like-kind exchange option was a clear breach of the accountant's standard of care. However, the case was sent back for trial on the issue of damages.[400]

---

[397] The trial court erred in failing to find that the accountant was the legal cause of the additional taxes. *Id*. at 91. Of course the plaintiffs first sold property at a gain. Without such an event there would never be any need for any tax deferral provision. The fact is the tax need not have been paid in the year of the sale, the accountant was hired to advise plaintiffs how to achieve this admittedly achievable result, and but for his negligence, no tax would have been due now!

[398] 182 F. Supp. 2d 637 (N.D. Ohio 2002). *See also* Hall v. Gill, 670 N.E. 2d 503 (Ohio App. 1995).

[399] *Id*. at 637.

[400] *Id*. at 638.

It is suggested that the correct approach to timing tax benefit damages is the approach of the *Bancroft* case. The amount of current additional taxes caused by the negligence of the tax advisor should be recoverable as core damages. Such additional taxes should include not only extra taxes paid over and above the correct amount, but also any taxes that could have been avoided with non-negligent, accurate advice. Any attempt to reduce such current damages by future tax benefits should be treated as an attempt by the defendant to reduce such damages and the burden of proving the future benefits should be placed on the defendant. By doing this, the perhaps insurmountable burden of predicting when, if ever, the new property will be sold, what will be the tax rate then, what will be the plaintiff's tax situation then etc, will be imposed on the negligent tax professional who created the need for such predictions rather than on the innocent taxpayer who sought reliable, professional advice.

The policy considerations furthered by this approach seem compelling. As an initial matter, it makes the innocent party whole, and places her or him in the same position they would have been with correct advice. This is the goal of the law in such cases.[401] Similarly, any *per se* rule that timing tax damages are not recoverable would absolve tax advisors from any liability for such types of erroneous advice, which, to me, seems unjustifiable.

I would now like to briefly respond to the position taken by Mr. Jeffrey Rich that timing tax damages are not recoverable.[402] As an initial matter I wish to note that Mr. Rich

[401] See *supra* Part II.

[402] Rich, *supra* n.367. See WOLFMAN ET AL., supra note 16 at 516n.73 in which Mr. Rich's position is characterized as "curious."

addresses the recoverability of lost tax benefits not just in tax malpractice situations but in securities liability and other areas as well.[403] I only express my disagreement as to the tax malpractice area, not any of the others.

In his article, Mr. Rich seems to rely on two cases that hold lost timing tax benefits are not recoverable.[404] The cases are *Alpert* v. *Shea Gould Climenko & Casey*[405] and *DCD Programs Ltd*. v. *Leighton*.[406] Both of these cases, however, are securities fraud cases. Damages in such cases are recessionary, not benefit-of-the-bargain damages as are awarded in the tax malpractice area.[407] Accordingly, neither of these cases seems relevant.

The crux of Mr. Rich's conclusion that timing tax benefits are not recoverable seems to be based ultimately on the inherent speculativeness of attempting to predict the value of the future tax benefits. In an example of a failed like kind exchange under I.R.C. section 1031 he presents the uncertainties as follows:[408]

> But in our example, what is the present value of the deferred tax? We do not know for certain because we cannot predict when, or even if, the property received will be disposed of by the transferor, whether the

[403] *Id*. at 217.

[404] *Id*. at 218-19

[405] 559 N.Y.S. 2d 312 (1st Dep't. 1990)

[406] 90 F. 3d 1442 (9th Cir. 1996)

[407] See text accompanying notes 58-59, *supra.*

[408] Rich*, supra* n. 367 at 219.

> disposition will be a taxable event, and what the transferor's marginal tax rate will be for the taxable year in which the deferred gain is ultimately recognized. In fact, we do not even know if there will be a federal income tax in effect for the year of the property's disposition.

Although Mr. Rich summarizes the uncertainties rather articulately, and while I agree that predicting the value of future tax benefits may be speculative, I nevertheless disagree with his conclusion. Mr. Rich's position seems to be based on the following logic:[409]

1. Damages are recoverable only for additional taxes caused, not for taxes that are owed anyway.
2. The plaintiff has the burden of proving the damages proximately caused by the negligence.
3. The damages, that the plaintiff must prove, are the difference between the additional taxes payable now, minus the present value of the future tax benefits.
4. The value of future tax benefits are virtually impossible to predict (i.e., they are speculative)
5. Therefore, plaintiff can never prove damages and can never recover timing tax benefits.

I disagree with step three. The appropriate damages that must be proven by the

---

[409] *Id.* at 218-19.

plaintiff are only the additional taxes incurred *this year*. Why must the plaintiff attempt to predict his future tax situation until eternity? He or she sought advice on how to minimize tax *this year* when the exchange of properties, etc., occurred. If through negligence the advice is faulty, he or she need only prove the damages caused *this year*. If the tax advisor wishes to reduce these damages by what will happen in the future, the advisor, as in *Bancroft,* should bear the burden of proving the future benefit. Admittedly, this might not be possible due to the inherent speculativeness of the task. However, this burden belongs on the negligent advisor rather than on the innocent client. The result advocated by Mr. Rich would absolve all tax advisors of any liability in connection with all tax deferral transactions.[410]

C. Tax Benefits of the Injury

When the injury caused by a negligent tax practitioner generates some tax benefit to the plaintiff, does such tax benefit reduce the amount of recoverable damages? To illustrate, what if as a result of negligent advice, a plaintiff incurs additional state income taxes of $100,000. If such taxes are deductible for federal income tax purposes and the deduction results in tax savings of $35,000, are the recoverable damages $100,000 or $65,000 ($100,000 - $35,000)? Alternatively, what if, as a result of negligent advice, a plaintiff

[410] If, notwithstanding the fact that the defendant's negligence caused the need to predict future tax results, a court is uneasy about predicting, or unwilling to ignore, future tax benefits in determining recoverable damages, the following suggestion is offered. Perhaps it is possible to follow the approach taken by the court in Hosfelt v. Miller, 2000 Ohio App. LEXIS 5506. (See text accompanying notes 230-31, *supra)*. In *Hosfelt,* the defendant attorney failed to inform a surviving widow that she could disclaim property to be inherited from her deceased husband. Although it normally is difficult , if not impossible, to determine damages from such negligence since it too involves predicting future tax results, (*i.e.* when the widow dies), nevertheless, the court held that when the widow died eleven months after her husband, this fixed the amount of damages and eliminated any "speculativeness." Id. at *14-15. Similarly, if in a tax deferral situation, (i.e. a failed like kind exchange under IRC § 1031) the plaintiff were to sell the acquired property relatively soon after the year of the exchange and the plaintiff realized a tax benefit due to having a higher basis, such determinable benefit might reduce the plaintiff's recovery. Of course, such benefit would need to occur before trial.

incurs $60,000 in attorney fees for representation at the ensuing IRS audit and subsequently to litigate the matter. If such fees are deductible and the deduction results in tax savings of $15,000, are the recoverable damages the full $60,000 or only $45,000 ($60,000 - $15,000)?

The simple answer is that there is no reduction in recoverable damages as a result of any tax benefits to the plaintiff resulting from the complained-of negligence.[411]

In *Burdett* v. *Miller*,[412] a case involving a breach of fiduciary duty suit against an investment advisor who was a CPA and a professor of accounting, Judge Posner gave a very direct and definitive answer: [413]

> The remaining question is the measure of damages for the breach of fiduciary duty. Burdett argues and the district judge agreed that the damages should not be reduced by the amount of money that Burdett was able to save by deducting the loss of her investment from her income on her tax returns. This is the correct general rule.
> . . . Suppose, to take a simpler case, that Miller had tortiously destroyed Burdett's Ming vase worth $10,000 and Burdett had deducted this amount as a casualty loss on her federal income tax return, garnering a tax saving of $3,000. Miller could not in the

---

[411] *See e.g.*, Burdett v. Miller, 957 F. 2d 1375, 1383 (7th Cir. 1992); Jobe v. International Insurance Co., 933 F. Supp. 844, 859-60 (D. Ariz. 1995), *order withdrawn pursuant to settlement,* 1 F. Supp. 2d 1403 (D. Ariz. 1997). Billings Clinic v. Peat Marwick Main & Co., 797 P. 2d 899, 912-13 (Mont. 1990). See also Rich, *supra n. 367, 80 Tax Notes at 221.*

[412] *Id*.

[413] *Id*., at 1383.

> ensuing tort suit deduct the $3,000 from the damages due Burdett. The tort caused a harm of $10,000, and the fact that the plaintiff was able to lay off a part of the harm on someone else – the taxpayer--is not a good reason to cut down the tortfeasor's damages. It is true that the result is a windfall to the plaintiff, but this is better than an equivalent windfall to the tortfeasor. . . . (citations omitted)

D. Tax Consequences of the Recovery – Gross-Up

As a corollary to the issue addressed in the previous section, should the tax consequences of the recovery to the plaintiff be taken into account in determining the amount of recoverable damages? More precisely, if the receipt of damages is includible in the gross income of the plaintiff, should the amount of the damage award be increased (grossed-up) to offset the tax? To illustrate, assume a plaintiff is in a forty percent tax bracket (federal and state) and that total damages are $60,000. If damages of $60,000 are awarded and they are subject to tax, the plaintiff will be left with only $36,000 (i.e., $60,000 - $24,000 (40% of 60,000)) after tax. In order to get $60,000 after-tax dollars into the plaintiff's hands it would be necessary to gross-up the damage award to $100,000.

There seem to be competing policy concerns here. On the one hand, not to gross-up, *i.e.,* to ignore any tax consequence of the damage award, would be consistent with the approach taken with respect to any tax benefit generated by the injury, -- it is disregarded. On the other hand, if the focus is on the basic theory of damages in this area -- to put the plaintiff in the same position as she or he would have been with non-negligent advice,-- then it would be necessary to gross-up any damage award,

On this issue, unlike the situation with respect to tax benefits of the injury, the few cases on point have split. In *Pytka* v. *Gadsby Hannah*, *LLP*[414] the court explicitly refused to gross-up the tax damages awarded the plaintiff.[415] The reason, though, was because there was "uncertainty between the experts as to whether the major portion of the judgment [*i.e*., the taxes] will be taxed by the Federal authorities."[416] Also, the court seemed to believe that there would be no tax on the judgment.[417] In *Oddi* v. *Ayco Corp*.[418] the Seventh Circuit affirmed the district court's damage award that included gross-up for the taxes to be incurred by the plaintiff on the damage award.[419] *Oddi* was followed by *Jobe* v. *International Ins. Co*.[420]

In *Oddi,* it is noteworthy that the Seventh Circuit refused to accept the defendant's argument that there should be consistency between how tax benefits of the plaintiff's injury are treated with how the tax burden on the damage award is treated. The defendant here

[414] 2002 Mass. Super. LEXIS 461

[415] *Id*. at *26.

[416] *Id.*

[417] *Id.*

[418] 947 F. 2d 257 (7th Cir. 1991).

[419] *Id*. at 267-68.

[420] 933 F. Supp. 844, 860 (D. Ariz. 1995), *order withdrawn pursuant to settlement,* 1 F. Supp. 2d 1403 (D. Ariz. 1997). *Jobe* is an insurance coverage case between a law firm and its professional liability insurer arising from an underlying tax malpractice. *Id*. at 850. However in its analysis the court listed what damages are appropriate in a tax malpractice litigation. *Id*. at 860.

argued that since the damage award was not reduced due to the deductibility of the plaintiff's legal fees, so too the tax imposed on the damage award should be ignored.[421]

In theory, if the goal of the law is to put the injured party as close as possible to where they would have been with non-negligent tax advice, then the *Oddi* approach should be followed and the damage award should be grossed-up. This, however, assumes the damage award is taxable, which may not be certain.[422]

V. Brief Observations on the Estate Planning/Estate and Gift Tax Area

Although I had originally intended a more extended discussion, since this article is already quite voluminous I will limit myself here to several brief observations with respect to the very broad estate planning/estate and gift tax area. As a preliminary matter, I wish to note that all of the principles discussed heretofore, of course, apply. Thus, if due to negligence an estate tax return is filed late and additional taxes incurred (for instance, by losing the right to utilize the alternate valuation date), the additional taxes are recoverable as well as all of the other normally recoverable elements of damages.[423] However, having said this, I wish to note that this area of law may have unique issues in determining how much additional taxes are incurred that are very different from income tax malpractice situations.

---

[421] *Oddi, supra*, note 418, 947 F. 2d at 268.

[422] See e.g., Burgess J.W. Raby & William L. Raby, Excludability of Tax Loss Reimbursements, 100 Tax Notes 1689 (9/24/03). Robert W. Wood, Tax Treatment of Legal Malpractice Recoveries, 114 Tax Notes 665 (2/12/07); Anthony E. Rebollo, Responding to "Gross-Up" Claims in Tax Malpractice, 104 J. Tax. 353 (June, 2006).

[423] *See e. g*., Cameron v. Montgomery, 225 N. W. 2d 154 (IA. 1975). *See also* Estate of Lohm, 269 A. 2d 451 (Pa. 1970) (issue arose in proceedings to fix executors' commission and estate's counsel fees. Based on the malpractice, counsel fees were denied.)

For example, assume a tax advisor negligently advised that a transfer of $100,000 would not constitute a taxable gift when, in fact, it did. Assume further that the taxpayer still has available the lifetime exemption from gift tax of $1 million[424] and that when the error was discovered, the lifetime exemption was utilized and no immediate gift tax was due. Was the taxpayer damaged? No immediate gift tax was incurred. But now a portion of the lifetime exemption was utilized, when perhaps it need not have been. If the taxpayer makes additional gifts above the remaining $900,000 exemption gift tax will be incurred. But are such damages too speculative to be recoverable? There is no certainty that such gifts will ever be made, or if they are made, when. In addition, we have the normal uncertainties in trying to predict future taxes -- will the tax still be in existence, what will be the tax rates, etc. In short, the structure of the transfer taxes differs from the income tax, and the determination of extra taxes caused by any malpractice may be very different, and difficult, to determine, and perhaps too speculative to recover.

A similar issue exists with respect to errors in estate planning. If there is a defect in an estate plan, any extra taxes may not be incurred for many years until either the death of the person for whom the planning was done, or until the death of that person's spouse.[425] Any present estimate of the tax damages may be too speculative to be recoverable.[426] While the speculativeness might be mooted if the person whose death fixes the damages happens to

---

[424] *See* IRC §2505 (a), 26 U.S.C. §2505 (a). For convenience, the annual gift tax exclusion (currently $12,000) of IRC § 2503 (b), 26 U.S.C. § 2503 (b) is ignored.

[425] *See e.g.,* Harmeyer v. Gustafson, 2001 Minn. App. LEXIS 175 (2001). See text accompanying notes 225-29, *supra.*

[426] *Id*.

die relatively soon, [427] this may very well not occur. We may have a situation where there is a definite, legally cognizable wrong, and while ancillary damages such as corrective costs might be recoverable, there might be no practical ability extant to recover the main element of damages -- the additional taxes caused.[428]

This state of affairs might put a premium on taking corrective action quickly and actively rather than on sitting back, leaving the status quo and hoping to be made whole via a suit for damages after the additional taxes are ultimately incurred. It may in fact explain why the Reverend Porter's family in *Porter v. Ogden, Newell & Welch*[429] went to such lengths -- having the Florida law changed -- in their attempts to correct the estate planning error that was made.

VI. Conclusion

Attempting to obtain a comprehensive overview of the damages recoverable as a result of tax malpractice is a bit like trying to put together a large jigsaw puzzle. It takes a lot of work and patience. There are many pieces that need to be examined, analyzed and then fit together. When the work is completed, a big picture emerges, interesting, and with vivid color and detail.

Since this area is governed by tort and contract law, areas traditionally governed by state law, differences among the various states are to be expected, and, in fact, exist.

---

[427] *See e.g.*, Hosfelt v. Miller, 2000 Ohio, App, LEXIS 5506. Cf Camenisch v. The Superior Court of Contra Costa Co., 52 Cal. Rptr. 450, 456 (Cal. App. 1996) (court refers to situation where speculative damages might become recoverable if they mature before trial).

[428] See Martin D. Begleiter, *First Let's Sue All the Lawyers – What Will We Get: Damages for Estate Planning Malpractice*, 51 Hastings L.J. 325 (2000). Based on a situation in an IRS private letter ruling, Professor Begleiter proposes an interesting possible solution to this problem – that the estimated present value of the future damages by deposited into a trust. When the tax damages are ultimately determined the amount in the trust would be utilized to pay the taxes and the balance returned to the defendant tax advisor. Id. at 360-63.

[429] F. 3d 1334 (11th Cir. 2001). See text accompanying notes 183-96, *supra.*

However, the overall contours of what is or is not recoverable are reasonably well defined and consistent. A caution is offered though in that even if several states seemingly follow the same rule or approach, it may be possible that the fine points, or the applicable procedural requirements, are nevertheless so different, that different results may eventuate for the same set of facts. Though not focused upon herein, an example of such procedural differences might be the determination of when a statute of limitations commences to run and whether it may be tolled.[430]

With respect to core or direct damages, each element of such damages needs to be addressed separately.

As to additional taxes caused by the malpractice, although not recoverable in New York,[431] there seems to be general consensus among most states that such amounts are recoverable.[432] The cases emphasize that only *additional* taxes, not all taxes, incurred are recoverable.[433] There is disagreement as to when such taxes are deemed incurred. In one case an IRS assessment, or the assessment in conjunction with an IRS notice of deficiency, was held to fix the time when the tax was incurred.[434] Another court held a final Tax Court determination was necessary, notwithstanding a previously issued IRS notice of deficiency.[435] In yet another approach, one court accepted expert testimony as establishing the amount of state tax damages caused by the incorrect advice.[436]

---

[430] *See generally* Jacob L. Todres, *Investment in a Bad Tax Shelter: Malpractice Recovery From the Tax Advisor Is No Slam Dunk*, 107 *Tax Notes,* 217, 224 (4/11/05).

[431] *See* text accompanying notes 55-62, *supra.*

[432] *See* text accompanying notes 40-54, *supra.*

[433] *Id*.

[434] Thomas v. Cleary, 768 P. 2d 1090 (Alaska 1989).

The very basic issue in this area is how to determine the extra tax caused by the negligent advice. Although this may be self-evident in many instances,[437] it may involve the need to predict, or assume, many complex factors. For instance, in *Oddi v. Ayco Corp*.,[438] determination of the additional tax required reference to a life expectancy for the plaintiff and his wife, a spread between taxable and tax-free rates of return and a prediction of future income tax rates among other assumptions.[439] Courts, such as the trial court in *J.D. Warehouse v. Lutz and Co*.,[440] sometimes seem to lose perspective and focus. When a tax professional incorrectly advises how to avoid current tax on the sale of property involuntarily converted, it seems that any tax currently incurred that could have been avoided with correct advice should be recoverable. The fact that the client had already sold the property and nominally incurred the tax seems irrelevant.[441]

An area that seems to be in need of greater attention, and perhaps a different result, is how to measure damages when the tax advisor promises unrealistic results. In these "pie-in-the-sky" situations the courts seem to measure damages by the difference between the taxes actually incurred minus what taxes could have been payable with optimal advice.[442] They do not factor into this calculation the tax results promised by the tax advisor.[443] Certainly,

---

[435] Bronstein v. Kalcheim and Kalcheim, Ltd., 414 N. E. 2d 96 (Ill. App. 1980).

[436] Jameson, Money, Farmer & Co. v. Standeffer, 678 So. 2d 1061 (Ala. 1996).

[437] *See* text accompanying notes 75-78, *supra.*

[438] 947 F. 2d 257 (7th Cir. 1991), amended, 1992 U. S. App. LEXIS 1014 (7th Cir. 1992).

[439] *See* text accompanying notes 84-85, *supra.*

[440] 639 N. W. 2d 88 (Neb. 2002).

[441] *See* text accompanying notes 87-90, *supra.*

[442] *See* text accompanying notes 92-102, *supra.*

unscrupulous advisors would be more reluctant to promise "pie-in-the-sky" results if they were held responsible for their promises.[444]

With respect to the core damage of interest paid on a tax underpayment, three different views have emerged.[445] A majority[446] of states follows the traditional view allowing the recovery of such interest since it is a cost proximately caused by the tax professional's negligence. A minority view disallows recovery of such interest in order to prevent a windfall to the plaintiff. According to this view, if the plaintiff may recover such interest s/he will have had the unwarranted benefit of having had interest-free use of the IRS's money.[447] The third view is a reaction to the possibly harsh results of the no interest recovery view. Under this view a plaintiff may recover the interest differential—i. e., the difference between the interest paid and the interest earned on the underpaid taxes.[448] The two leading proponents of this view, however, took a very different procedural approach. In *Ronson v. Talesnick*[449] the plaintiff was initially awarded the full interest paid and the defendant had the burden of proving the plaintiff's earnings on the tax underpayment in mitigation.[450] In *Streber v. Hunter*[451] the plaintiff had the burden of proving the interest differential.[452]

---

[443] *Id.*

[444] But there could be a possibility that unscrupulous clients might exploit advisors if the change advocated was adopted. See text immediately preceding note 103, *supra*.

[445] *See* Part III. A.2, *supra*.

[446] *See* note 109 *supra*.

[447] *See* text accompanying notes 114-19, *supra.*

[448] *See* text accompanying notes 123-45, *supra.*

[449] 33 F. Supp. 2d 347 (D. N.J. 1999).

[450] *See* text accompanying notes 127-34, *supra.*

The most recent cases to focus on this issue as a matter of first impression rejected the no-interest view. They did however leave open the possibility that they might follow the *Ronson v. Talesneck* variation of the third view in that they might allow a defendant, in appropriate circumstances, to introduce evidence to reduce the amount of such damages awarded.[453]

With respect to the remaining core damages, there is uniform agreement that penalties and corrective costs incurred by the injured party are recoverable.[454] The limit of reasonableness for corrective costs may very well be illustrated by *Porter v. Ogden, Newell & Welch*,[455] in which the plaintiff mitigated damages by successfully lobbying the Florida legislature to change its law.[456]

The only other potential issue, which is really a non-issue, is to be wary of confusing corrective costs with the "American rule" that litigation costs of the malpractice action are not recoverable. Corrective costs are costs incurred by a plaintiff to mitigate, or attempt to mitigate, the damages resulting from the negligence. These costs – even if they involve attorney fees –are very different from the litigation costs of bringing the malpractice suit, and constitute recoverable damages.[457]

---

[451] 221 F. 3d 701 (5th Cir. 2000).

[452] *See* text accompanying notes 135-45, *supra.*

[453] *See* text accompanying notes 146-59, *supra.*

[454] See *supra* Parts III. A.4 &.3.

[455] 241 F.3d 1334 (11th Cir. 2001).

[456] *See* text accompanying notes 183-96, *supra.*

[457] *See* text accompanying notes 177-79, *supra.*

All damages caused by a defendant are recoverable including non-core, or consequential, damages. Although such damages are not limited to any predefined category or type, the damages must be foreseeable and proximately caused by the negligence. In addition, the damages may not be speculative. This means the fact of damages must be certain, even if the amount may yet be uncertain.[458] Since the question of whether some purported loss is speculative is very fact sensitive; no generalizations were attempted herein. Rather, a number of cases focusing on this issue were discussed.[459] These cases usually involved claims for lost income or lost business or investment opportunities[460] or the attempt to predict future taxes.[461] The difficulty in being able to project future taxes with any certainty is especially problematic in the estate planning, estate and gift tax areas.[462]

Damages for emotional distress or mental anguish are generally not recoverable in tax malpractice situations, though a number of exceptions exist in especially egregious situations.[463] Suicide is not a foreseeable result of tax malpractice.[464] Punitive or exemplary damages may be recovered in a state that generally permits the recovery of such amounts.[465]

With respect to attorney fees, whether they are recoverable depends on the nature of the fee. Those incurred to mitigate, or attempt to mitigate, damages are recoverable as

---

[458] *See* text accompanying notes 34-35 and 197-99, *supra.*

[459] *See* Part III. B.1 *supra*.

[460] *See* text accompanying notes 200-09, *supra.*

[461] *See* text accompanying notes 210-39, *supra.*

[462] *See* text accompanying notes 225-39 and Part V, *supra.*

[463] See Part III.B.2., *supra.*

[464] See Part III. B.3., *supra.*

[465] See Part III. B.4., *supra*.

corrective costs.[466] Fees incurred to prosecute the malpractice action are not recoverable under the "American rule."[467] With respect to recovery of the initial fee paid for the services that ultimately were performed negligently (and which could also be the initial fee of an accountant or other professional), the answer is a bit more doubtful.[468] There are a number of cases that permit the recovery of such amounts and this is probably the more accepted view. In *John Kohl & Co. P.C. v. Dearborn & Ewing*[469] the court very discerningly, permitted the recovery of the initial attorney fees but insisted the defendants receive credit for those portions that ultimately benefited the plaintiff.[470]

Although the general contours of recoverable versus non-recoverable damages are reasonably well established, a number of broader issues remain unresolved. Two of the most salient are the recovery of audit damages and whether the basic damage award should be grossed-up so that an injured plaintiff should be made whole on an after-tax basis. With respect to audit damages, there seems to be no discussion in either the reported cases or in the literature though in one case the court refused to award such damages.[471] From a policy standpoint, it seems difficult to permit the recovery of such amounts since any such recovery might imply that taxpayers have the right to play the audit lottery and to be free from IRS audit.

---

[466] *See* Part III.A.4. *supra*.

[467] *See* text accompanying notes 305-08, *supra.*

[468] *See* text accompanying notes 309-13, *supra.*

[469] 1997 WL 195469 at *7 (Tenn. App.).

[470] *See* text accompanying notes 319-20, *supra.*

[471] *See* text accompanying notes 361-64, *supra.*

With respect to gross-up of the damage award the few cases that focus on the issue disagree. One explicitly refused to permit gross-up while two others explicitly did permit it.[472] The court refusing to gross-up the award indicated that the basic damage award likely was not subject to federal tax.[473] Neither of the other cases explained why they did gross-up. Some of the existing literature suggests the issue may be moot, since it is not certain whether the recovery of tax malpractice damages is taxable.[474] From a theoretical standpoint, assuming the recovery is taxable, it seems gross-up is warranted. A damaged party should be made whole on an after-tax basis. Otherwise, despite the damage award, the party will still not be fully compensated.

If an injured party realizes some tax benefit as a result of the injury, it seems well established that the amount of damages recoverable is not reduced by the tax benefit.[475] Thus, if a tax advisor causes a plaintiff to overpay state income taxes, the full amount of the overpayment is recoverable as damages without regard to whether the plaintiff may deduct such state income taxes on her or his federal income tax return.

Finally, when a negligent tax advisor's error concerns a timing tax benefit rather than a permanent tax benefit, the normal rules for recoverable damages still ought to be applied.[476] Although some defendants and a commentator argued that such damages should never be recoverable because they are too speculative to ascertain,[477] I emphatically disagree. The

---

[472] Part IV. D, *supra*.

[473] Pytka v. Gadsby Hannah, LLP, 2002 Mass. Super. LEXIS 461 at *26 n.1.

[474] See note 422, *supra*.

[475] See Part IV. C, *supra.*

[476] See Part IV. B., *supra*.

court in *Bancroft v. Indemnity Insurance Co. of N.A.*[478] got it right. Any amount of avoidable current taxes caused by the negligence should be recoverable in full. If the defendant wishes to argue that some offsetting benefit will be available at some future time, the burden of proof properly belongs on the defendant. If it is too speculative to predict this future benefit, so be it! Any other approach would exculpate all tax advisors from ever bearing responsibility for errors concerning tax timing advice.

[477] *See* text accompanying notes 391-92, (defendants' argument in J.D. Warehouse v. Lutz & Co.,) and notes 402-10, *supra.*

[478] 203 F. Supp. 49 (W. D. La. 1962).