Litigation against tax preparers raises the question: Can a tax preparer really "rely in good faith, without verification, on information furnished by the taxpayer or third-parties?"

By Wilhelm Dingler, Esq. and William N. Holmes, CPA/ABV/CVA/CFE

Summary

Accountants have long-held the belief that a tax preparer "may in good faith rely, without verification, on information furnished by the taxpayer or by third parties." This belief seemingly arises from guidance found in professional accounting standards. However, accountants nationally are discovering through significant litigation losses that "reliance" on client-prepared tax return information may not actually be appropriate. Moreover, as you may determine from this article, professional accounting standards actually require much more of the tax preparer in certain situations. Accountants are in danger of being embroiled in litigation when they misunderstand tax preparation standards; particularly when their clients have engaged in related party transactions where losses ultimately occur (i.e. related party loans that cannot be repaid).

Professional Standards Require Due Diligence

The authoritative guidance for the preparation of income tax returns by certified public accountants is generally governed by the Code of Professional Conduct ("Code") published by the American Institute of Certified Public Accountants ("AICPA"), the AICPA Statements on Standards for Tax Services ("AICPA Tax Standards"), and U.S. Treasury Department Circular No. 230 ("Circular 230").[1]

Tax preparation standards state, "In preparing or signing a return, a member may in good faith rely, without verification, on information furnished by the taxpayer or by third parties. However, *a member should not ignore the implications of information furnished and should make reasonable inquiries if the information furnished appears to be incorrect, incomplete, or inconsistent either on its face or on the basis of other facts known to the member*…."[2]

Additionally, "When preparing a tax return, a member should consider information actually known to that member from the tax return of another taxpayer if the information is relevant to that tax return and its consideration is necessary to properly prepare that tax return. In using such information, a member should consider any limitations imposed by any law or rule relating to confidentiality."[3] What this statement tells us is that that accountants are vulnerable to second guessing. This article will attempt to provide some practical advice to, hopefully, forestall any such second guessing.

Related Party Transactions = Litigation Risk

Accountants are at greater risk of violating tax preparation standards and getting sued when a tax client is engaged in related party transactions (i.e. related party loans) where one or more parties (and in particular, minority investors) suffer a loss.

In this example, if an investor loses money and blames the loss on the related party loans, the investor may discover that the LLC Operating Agreement is in the tax preparer's files. If related party loans were prohibited by the Operating Agreement, the investor will likely allege that the

[1] Circular 230 will not be discussed herein as the relevant provisions are consistent with AICPA Tax Standards.

[2] ACIPA Statements on Tax Services Section 300.02 (effective January 2010). (emphasis added)

[3] ACIPA Statements on Tax Services Section 300.04 (effective January 2010).

accountant failed to consider that fact or follow up on it.

While the accountant may disagree that he/she was obligated to follow up on that information, the investor will state that the tax preparer ignored the implications of information furnished or available to the accountant and/or failed to make reasonable inquiries when the information furnished appeared to be "incorrect, incomplete, or inconsistent either on its face or on the basis of other facts known to the member." *Id.*

In the same example, if the related party loan was made to an entity or individual who was also a tax client of the tax preparer, and if the investor concludes (and believe us, they will) there was any reason for the tax preparer to believe that the borrower could not repay the loan, the investor will likely allege that the accountant ignored the implications of the information furnished and failed to require that the loans be written off, which would have led the investor to act in a manner differently than he/she did.

Risk Management

In situations where related party transactions have occurred, the tax preparer should carefully consider the practical meaning of: "A member should not ignore the implications of information furnished and should make reasonable inquiries if the information furnished appears to be incorrect, incomplete, or inconsistent either on its face or on the basis of other facts known to the member….".

The tax preparer should also carefully consider the practical meaning of " When preparing a tax return, the member should consider information actually known to that member from the tax return of another taxpayer if the information is relevant to that tax return and its consideration is necessary to properly prepare that tax return".

In addition, the preparer should rely upon many of the standard items one considers during a tax engagement. One such item is a detailed tax preparer checklist. A checklist will assist you in ensuring that you have addressed all the appropriate issues and, more importantly, provide you with written proof that you asked the right questions and relied upon information supplied by the client in response to those questions. The same can be true for utilization of organizers in ones' tax practice.

Preparers should consider having their client "designate" a contact person; the person to whom you will turn for questions as well as answers related to the taxpayer's financial information. It is upon this information you are entitled to rely and which can form the basis for your first line(s) of defense against claims.

In consideration of the above, the tax preparer is required to exercise "due professional care". Due professional can take the form of consultation regarding the matter with a risk management hotline sponsored by an insurance carrier, for example. In addition, one can resort to contacting local and national societies; many of whom provide risk management assistance or subject matter experts whose role is to assist practitioners with thorny issues and questions. One can always rely upon contact with an experienced accounting malpractice attorney, or a professional "standard of care" expert in addition to the above-noted suggestions for assistance. The bottom line is that an informed and proactive risk management approach to your tax preparation model can go a long way to avoidance of claims or related, negative, issues in your practice,

Wilhelm Dingler is the practice leader for accounting malpractice defense in the Seattle, WA office of Bullivant Houser Bailey and is the Chair of the Accountants' Specialized Litigation Group (SLG) for the Defense Resource Institute (DRI). Mr. Dingler devotes his practice to the defense of professionals, primarily accountants, attorneys and real estate professionals. He also provides risk management services and advice to accountants across the country on "hotlines" under contract with three national insurance carriers. A trial attorney for 35 years, Wilhelm has litigated hundreds of cases in state and federal courts in Washington, Pennsylvania, Virginia, Alaska, Texas and Oregon. He has provided legal counsel to thousands of professionals. Prior to his engagement in the private practice of law, Wilhelm served as an assistant attorney general for the State of Washington providing counsel to the state's industrial insurance agency. He may be reached at wilhelm.dingler@bullivant.com.

Mr. Holmes (CPA/ABV/CVA/CFE) is the Managing Partner of Holmes & Company, LLP, a certified public accounting and litigation consulting firm located in Portland, Oregon and Los Angeles, CA and is Vice-Chair of the Accountants' Specialized Litigation Group (SLG) for the Defense Resource Institute (DRI). Mr. Holmes is a seasoned litigation support professional with 26 years of experience focused on fraud, economic damages (including valuation) and accounting malpractice matters. Mr. Holmes serves on the Oregon Board of Accountancy Complaints Committee (BOACC), has published articles on the standard of care for accountants, is an invited speaker at national litigation conferences involving accounting malpractice and advanced damages topics, and assists trial lawyers nationally in complex litigation matters. He may be reached at wnholmes@pdxcpas.com