INVESTMENT IN A BAD TAX SHELTER: MALPRACTICE RECOVERY FROM THE TAX ADVISER IS NO SLAM-DUNK

By Jacob L. Todres

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Todres believes that the IRS has recently begun to aggressively pursue investors in the latest generation of tax shelters. As a result, many investors in those products will not only not obtain the sought-after tax benefits but will also incur substantial additional costs for interest, penalties, and representation before the IRS and, perhaps, in court, according to Todres. He says that one instinctively imagines that the shelter investor could recover those costs and be made whole by means of a malpractice suit against the negligent tax advisor who opined that the shelter was effective. It is Prof. Todres’s view that when the tax adviser acted only as such, and not as a promoter or seller of the shelter, recovery may not be so certain. Todres finds several defenses. Initially, the mere error in judgment rule might be a substantial obstacle to recovery. Under that rule, an attorney is not liable for an error in judgment on some unsettled proposition of law, and the shelters, almost by definition, attempt to exploit instersticies or ambiguities in the tax law. Todres’s second obstacle to recovering damages is the need to choose the correct statute of limitations. Not only will the typical situation involve several possible states with different statutes, but it is also necessary to determine when the statute begins to run, whether tolling of the statute is permitted, and as the plaintiff in Seippel v. Jenkens & Gilchrist learned to his dismay, what the forum state’s choice of law rule provides. Finally, Todres finds enigmatic language in Loftin v. KPMG, LLP that might impose yet a third obstacle, depending on how the language is construed.

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With the enactment of the passive activity loss rules in the Tax Reform Act of 1986, Congress effectively shut down almost all of the then-prevalent tax shelters for individuals. Since the early 1990s new types of tax shelters were developed by Wall Street inventors for both corporations and individuals. Many of them had very exotic names such as BOSS, son-of-BOSS, COBRA, FLIP, BLIP, and so forth. According to press reports, these shelters probably reduced federal tax revenues by several billions of dollars. Although perhaps slow to realize what was happening, the IRS eventually caught on and has been aggressively going after the shelter investors as well as the professionals — attorneys and accountants — who created and sold those shelters. Similarly, Congress became interested and enraged by the audacity of those shelters and enacted new legislation as part of the American Jobs Creation Act of 2004. While the jury may still be out on whether all, or perhaps only some, of those shelters were abusive, as the IRS Shelter Report at 3, indicating that a partial analysis of just four types of shelters sold by KPMG generated claimed losses of $5.8 billion and that 169 BLIPs participants reduced tax revenues by $1.4 billion. See also Lynneley Browning, “KPMG Developed New Version of Tax Shelter IRS Had Disallowed,” The New York Times, Aug. 26, 2004 at C1 (Government Accountability Office estimated federal revenue loss of $33 billion over last 10 years); Ken Rankin, “Tax Shelters Come Under Senate’s Harsh Scrutiny,” 17(22) Accounting Today at 3 (Sen. Norm Coleman, R-Minn., estimated federal revenue loss of between $33 billion and $85 billion).


2See U.S. Tax Shelter Report at 3, indicating that a partial analysis of just four types of shelters sold by KPMG generated claimed losses of $5.8 billion and that 169 BLIPs participants reduced tax revenues by $1.4 billion. See also Lynneley Browning, “KPMG Developed New Version of Tax Shelter IRS Had Disallowed,” The New York Times, Aug. 26, 2004 at C1 (Government Accountability Office estimated federal revenue loss of $33 billion over last 10 years); Ken Rankin, “Tax Shelters Come Under Senate’s Harsh Scrutiny,” 17(22) Accounting Today at 3 (Sen. Norm Coleman, R-Minn., estimated federal revenue loss of between $33 billion and $85 billion).
government claims, or simply aggressive, as the industry claims, one thing is clear: Many of the shelter investors will not obtain the sought-after tax savings and will incur substantial interest, penalties, and other costs as a result of their participation in the shelters. For instance, the IRS has reported that more than 1,500 taxpayers accepted its settlement offer for son-of-BOSS shelter participants even though the IRS's settlement terms required the taxpayers to concede the entire tax owed, plus interest, plus significant penalties — typically 10 percent to 20 percent of the unpaid tax (unless the transaction was previously disclosed to the IRS).4

Normally, when a tax professional gives a client negligently incorrect advice, the client can recover the damages incurred from the tax professional through a malpractice suit.5 Those same general principles apply to determine whether and how much an investor/participant in one of these failed tax shelters may recover as damages from the tax adviser. In fact, several early cases have already reached the reporters6 and several others were reported in the pages of Tax Notes.7 The most notable and novel development in this area is the attempt by the Jenkins & Gilchrist law firm, apparently one of the notable and novel developments in this area is the attempt by the Jenkins & Gilchrist law firm, apparently one of the major players in the current generation of tax shelter promoters, to walk away from all, or most, of the numerous suits brought against it through a single payment of $75 million to settle the class-action suit brought against it. Whether that will be successful remains to be seen.8

From a gut level, it would seem obvious that relief should be available from a tax adviser who opined — in exchange for very high fees, sometimes even billed as a percentage of the expected tax savings — that a tax shelter was effective when in fact the transaction was totally devoid of any business purpose or economic substance and was patently invalid. However, I believe recovery from the errant tax adviser might not be so certain because, in addition to the normal elements of the malpractice cause of action that will need to be established, two requirements under current malpractice law might prove unexpectedly difficult to meet or comply with. Those obstacles to recovery, which are actually quite common and normally function to enforce two well-defined policy concerns, are the mere error in judgment rule and the statute of limitations. Also, there is language in a recent malpractice case involving a tax shelter of recent vintage that is very enigmatic and may create yet another obstacle, depending on how the enigmatic language is interpreted. That obstacle would revolve about the requirement that there be actual recoverable damages before a malpractice suit could be brought.

This article will briefly review the general rules governing malpractice recoveries in the tax context and then focus on the two obstacles as well as on the possible third obstacle that might prove especially troublesome when attempting to recover damages from a negligent tax adviser. Plaintiffs’ lawyers will need to overcome those obstacles if they are to bring successful suits. Defendants’ lawyers will try to hide behind those obstacles to prevent the imposition of damages on their clients. However, this article will focus only on the common law malpractice cause of action, though suits for tax malpractice recovery typically allege other causes of action, both common law, such as fraud, breach of fiduciary duties, and so forth, as well as federal causes of action, such as securities law and RICO violations.

In this article the terms “tax shelter” and “tax shelter transaction” will be used in a nontechnical, colloquial way to refer to a transaction (or series of interrelated transactions or steps) that seeks to generate some type of tax deduction or credit to offset other income. That is the ultimate purpose for entering into the transaction. The subject of the transaction itself is not otherwise of any particular concern to the shelter investor/participant apart from the sought-after tax benefit. That situation should be distinguished from other types of tax advice, like: What is the most tax efficient way of disposing of an asset or business, how to report a transaction for tax purposes or whether to engage in a taxable transaction or a tax-free reorganization and, if the latter, what type of reorganization, all of which have an intrinsic purpose other than to simply generate a tax deduction or loss.

I believe two of the early reported cases9 are both the harbingers and paradigms of the types of malpractice cases that will result from the IRS’s recent crackdown on the current generation of tax shelters. Both of those cases

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9 Loftin v. KPMG LLP, 2002 U.S. Dist. LEXIS 26909 (S.D. Fla. 2002); Jacoboni v. KPMG LLP, supra note 6.
involving Foreign Leveraged Investment Program (FLIP) shelters and name KPMG and Brown & Wood (now Sidney Austin Brown & Wood), as defendants. Those cases will be summarized briefly and their facts will then be used as a focus for the ensuing discussion.

In Loftin v. KPMG LLP, the plaintiff sold stock in 1997 and netted capital gains of $30 million and $65 million, respectively. On depositing the proceeds from the 1997 sale, the plaintiff’s banker encouraged him to retain KPMG for planning purposes regarding the $30 million capital gain. The plaintiff met with KPMG and was presented with the FLIP tax planning strategy. If effective, the FLIP strategy would generate large capital losses to offset the capital gains, thereby saving the plaintiff the tax on the capital gain. KPMG assured the plaintiff that the FLIP strategy complied with IRS rules and regulations and would withstand an IRS audit. The plaintiff decided to use the FLIP strategy. He then retained KPMG as well as another intermediary firm to implement the strategy. KPMG was also retained to prepare his 1997 tax return. KPMG never delivered its promised tax opinion letter, but the plaintiff did receive a “concurs opinion” from a law firm, presumably Brown & Wood. In Jacoboni, the court noted that the plaintiff alleged that KPMG prohibited independent review of the FLIP strategy as the strategy was “confidential.” Jacoboni was later audited by the IRS and paid substantial additional amounts. He then filed suit, asserting a number of state law claims similar to those asserted in Loftin as well as a federal RICO claim against the defendants.

In Jacoboni, as in Loftin, the court held that the federal RICO claim was barred by the Private Securities Litigation Reform Act of 1995 because it alleged conduct that would be actionable as fraud in the purchase or sale of securities. KPMG encouraged the plaintiff to settle with the IRS.

In Loftin, KPMG later filed suit against KPMG, Brown & Wood, and the other participants in the FLIP strategy. The complaint included allegations of fraud, breach of fiduciary duty, negligent misrepresentation, malpractice against KPMG and Brown & Wood, and a RICO claim. Most of the court’s opinion in Loftin addressed whether the RICO claim was barred by the Private Securities Litigation Reform Act of 1995 and ultimately held that it was. Insofar as the other allegations were concerned, the court held all of them were premature because Loftin had not yet settled with the IRS and therefore there were no damages, the presence of which were an essential element for all of those other causes of action.

In Jacoboni v. KPMG LLP, the operative facts were quite similar to those in Loftin. In Jacoboni, the plaintiff had $28 million of capital gain in 1997. Jacoboni also was referred to KPMG by his banker. KPMG recommended a FLIP strategy, which it described as “bullet proof.” KPMG required the plaintiff to also retain a designated intermediary firm to effectuate the strategy. Unlike in Loftin, KPMG never delivered its promised tax opinion letter, but the plaintiff did receive a “concurs opinion” from a law firm, presumably Brown & Wood. In Jacoboni, the court noted that the plaintiff alleged that KPMG prohibited independent review of the FLIP strategy as the strategy was “confidential.” Jacoboni was later audited by the IRS and paid substantial additional amounts. He then filed suit, asserting a number of state law claims similar to those asserted in Loftin as well as a federal RICO claim against the defendants.

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obligation to perform the task undertaken diligently and competently. In practice, those two standards, although emanating from different areas of the law, are almost identical. The professional therefore must exercise reasonable competence and diligence under the circumstances to avoid malpractice exposure.36

While the basic standard of care is almost identical under tort and contract theories, other aspects of the causes of action or defenses thereto might differ depending on which theory is used. Differences are usually encountered in the statute of limitations (both how long and when it commences), the measure of damages, to whom liability extends (that is, privity), and evidentiary matters, such as the need for expert testimony.37 Several recent cases emphasize that differences remain between the two theories and the need to carefully comply with the requirements of each. For instance, in Sorenson v. HeR Block Inc.,38 the court denied recovery under many different tort theories, while permitting recovery under a contract theory.39 In Tony Smith Trucking v. Woods & Woods Ltd.,40 the plaintiff attempted to qualify for the longer five-year contract statute of limitations instead of the three-year tort statute by arguing that when their accountant signed the IRS power of attorney form to represent them at audit a contract was formed. The court rejected that argument and held that 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, that is simply an allegation of negligence, not breach of contract.41

Normally the malpractice tort asserted against an attorney is simply 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.42 Because tax law generally is perceived as a specialty, the standard of care may be higher than in other attorney malpractice situations.43 The four elements that must be established for a prima facie cause of action are: (1) a duty owed by the attorney to the plaintiff; (2) breach of that duty; (3) injuries suffered by the plaintiff; and (4) proximate cause between the injury suffered and the breach of duty.44

35See id.
36See id.
37See id.
39The alleged torts included negligence, breach of fiduciary duty, professional malpractice, intentional/negligent infliction of emotional distress, and intentional or negligent misrepresentation. Id. at *3-4. In addition to obtaining recovery under a breach of contract claim, the plaintiff also recovered under the Massachusetts Unfair and Deceptive Trade Practices Act. Id. at 61-62.
41Id. at 330-31.
42Wolfman et al., supra note 5 at section 601.21.
43See id. at section 603.3. See also 3 Mallen and Smith, supra note 5 section 23.26, and Malpractice I, supra note 5 at 553.
44Wolfman et al., supra note 5 at section 601.21. The essence of the cause of action is comprised of the four elements listed despite the fact that some courts sometimes list only three.

Footnote continued on next page.
The standards for accountants are similar to those of the attorney. 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 four elements of the prima facie cause of action against the accountant are the same as those to establish a cause of action against an attorney.45 Many cases simply equate the elements of the causes of action and the standard of care in accountant and attorney situations.46 Nevertheless, there are differences between the two professions that must be kept in mind. For instance, there might be different statutes of limitations47 and, because the precise nature of the work each professional is called on to do may differ, a suit against an attorney and accountant stemming from the same set of facts might have different outcomes.48

While the normal malpractice cause of action involves the tort of negligence, other torts are also encountered. For instance, in a recent case,49 in addition to claims for malpractice, there were allegations of other negligence grounds and claims for breach of contract, breach of fiduciary duty, intentional or negligent infliction of emotional distress, breach of covenant of good faith and fair dealing, intentional or negligent misrepresentation, and false and deceptive trade practices under state law.50 Alleged violations of federal securities laws51 and the RICO statute52 might also be encountered.

B. Measure of Damages

The general tort measure of damages, which also applies in malpractice situations, is for the plaintiff to recover for all injuries proximately caused by the defendant’s negligent conduct. The plaintiff may recover the difference between his or her current economic position and the position he or she would have been in had the defendant performed nonnegligently.53

All damages caused are recoverable, even indirect or consequential damages, as long as they are the proximate result of the defendant’s negligence.54 However, most courts do not award damages for emotional pain and suffering when, such as in the malpractice area, the basic injury suffered is only an economic one.55 To be recoverable, the damages must be actually incurred, not merely speculative ones that may arise in the future.56 Punitive or exemplary damages may be recoverable in appropriate circumstances.57

The normal duty generally recognized to mitigate damages resulting from a defendant’s negligence is also applicable.58 Similarly, under the so-called American Rule, attorney fees incurred to bring the malpractice action are not generally recoverable.59 Those nonrecoverable litigation costs should be distinguished from attorney or accountant fees and other costs incurred to correct, or attempt to correct, the effects of the defendant’s negligence that are normally recoverable as consequential damages.60

In applying those general principles to the tax malpractice context, basic recoverable damages would normally include any penalties incurred and any corrective costs such as accounting or legal fees to file amended or late returns or to reduce, or attempt to reduce, penalties or other damages, whether by negotiation or litigation.61 Regarding interest incurred, there is a split among the states. Many states permit the recovery of interest on the simple theory that the wronged plaintiff incurred those costs solely because of the malpractice.62 Other states deny recovery for interest because they believe such a recovery would result in a windfall for the plaintiff. Those states believe that as long as the plaintiff kept the tax money rightfully due the government, the plaintiff was receiving a benefit to which he or she was not entitled, that is, the time-value of the money — the interest. Correspondingly, the government, which was properly entitled to the tax money, was entitled to the interest but was deprived of it. Paying interest to the government, according to that view, simply rectifies the situation between the plaintiff and the government and

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53 Wolfman et al., supra note 5 at section 605.1.1. See generally Malpractice I, supra note 5 at 643-45.
54 Wolfman et al., supra note 5 at section 605.1.2.
55 Id. See also, e.g., McCulloch v. Price Waterhouse LLP, 971 P.2d 414 (Or. App. 1998).
56 Wolfman et al., supra note 5 at section 605.1.3.
57 Id. at section 605.2.2 at p. 473.
58 Id. at section 605.1.1.
59 Id. at section 605.2.1; Malpractice I, supra note 5 at 644.
60 Id. See also Malpractice I, supra note 5 at 644.
61 Id. Wolfman et al. supra note 5 at section 605.2.1; Malpractice I, supra note 5 at 644.
II. First Obstacle: Mere Error in Judgment Rule

Professionals, especially attorneys, are frequently called on to exercise judgment to resolve issues that are uncertain and subject to disagreement. To subject an attorney to malpractice liability simply because a judge ultimately disagrees with a judgment call would be unfair and place too great a burden on the legal profession. Because of those concerns, under the mere error in judgment rule it is universally recognized that an attorney is not liable for an error of judgment on an unsettled proposition of law. As other leading commentators present the rule, neither lawyers nor accountants are infallible and the law does not impose on them any implied guaranty of result. As long as their opinion is based on adequate research and careful consideration of the matter the fact that their judgment on a doubtful or unsettled area of law turns out to be incorrect will not give rise to malpractice liability.

The classic mere error in judgment rule is illustrated by Smith v. St. Paul Fire & Marine Insurance Co. and Martinson Manufacturing Co. v. Seery. In Smith, the attorney for an estate was asked whether obtaining securities from the estate by means of a Louisiana judgment in possession would constitute a distribution for federal estate tax alternate valuation purposes. If it did constitute a distribution, obtaining the judgment in possession would be detrimental to the estate because it would prevent the estate from benefiting from expected further declines in the value of securities owned by the estate. The attorney advised that a Louisiana judgment in possession did not constitute a distribution for federal estate tax purposes, and the estate obtained a judgment in possession. That advice turned out to be incorrect and resulted in the estate incurring increased federal estate tax of more than $14,500. In a suit against the attorney for malpractice, the court held the attorney was not liable, despite the fact that his advice was wrong. When the advice was given, there was no case law on point, and the evidence established that many Louisiana lawyers believed, as did the defendant attorney, that the judgment in possession was not a distribution for federal estate tax purposes. The evidence also established that the defendant attorney was knowledgeable concerning both the Louisiana judgment in possession law and the relevant federal estate tax law. As a result, the court held that the attorney, although ultimately wrong, was not negligent but had exercised proper skill and professional judgment.

In Martinson, the plaintiff corporation sought to acquire a loss corporation to use its net operating losses against its own income. The availability of the NOLs depended on avoiding the applicability of the pre-1982 version of IRC section 334(b)(2). Relying on a plan devised by its counsel, the corporation engaged in the transaction. After the plaintiff’s accountant took the position that the transaction was ineffective and the defendant attorney acquiesced, an action for malpractice was brought against the attorney. On appeal, the Iowa Supreme Court noted that there was no case law authority interpreting the relevant portion of the pre-1982 section...
As a result, the court accepted the defendant attorney’s contention that because “the application of the provision [section 334(b)(2)] was a matter over which reasonable doubt would be entertained by well-informed lawyers” the trial court was obligated to rule in the defendant’s favor. The Iowa Supreme Court held that the law does not impose an implied guaranty of results on professionals:

If an attorney acts in good faith and in an honest belief that his acts and advice are well founded and in the best interest of his client, he is not held liable for a mere error of judgment. A fortiori, an attorney is not liable for an error in judgment on points of new occurrence or of nice or doubtful construction, or for a mistaken opinion on a point of law that has not been settled by a court of last resort and on which reasonable doubt may well be entertained by informed lawyers.

Although the leading treatise on attorney malpractice liability states that the error in judgment rule on an unsettled proposition of law is “universally recognized,” an alternative approach might be beginning to emerge. In Williams v. Ely, the Supreme Judicial Court of Massachusetts held that if the law is unsettled the client must be advised of the unsettled status of the law and given the opportunity to knowingly elect from among available alternative courses of conduct. Failure to inform the client would give rise to malpractice liability, despite the fact that the advice actually given was otherwise justifiable under the mere error in judgment rule.

Similarly, in Wood v. McGrath, North, Mullin & Kratz, P.C., the Nebraska Supreme Court followed the Williams approach and held that the mere error in judgment rule (which the court referred to as the doctrine of judgmental immunity) did not apply to an attorney’s failure to inform a client of unsettled relevant legal issues. The court, however, reaffirmed its basic adherence to the mere error in judgment rule and that “an attorney’s ultimate recommendation in an area of unsettled law is immune from suit.”

If the mere error in judgment rule were applied simplistically to our facts, there is a reasonably good chance that both advisers, the accountant and attorney, could be exonerated from malpractice liability. Neither gave a clean opinion that the FLIP worked but rather a more-likely-than-not opinion. Such an opinion presumably explained the uncertainty in the law and concluded with the professional’s judgment that the desired tax benefits were more likely than not available. Because the area of tax law involved certainly has not been settled by a court of last resort and is one on which reasonable doubt may be entertained by informed professionals, assuming each professional did adequate research, that would seem to be the paradigm case to apply the mere error in judgment rule. Indeed, even if the more demanding Williams v. Ely approach were followed, it would seem that the tax advisers would still avoid liability as long as their opinion was well-crafted and spelled out the relevant options (the FLIP works vs. it does not work) so the client was informed of the options and understood that the professional was recommending one of the options (it works) over the other.

On closer examination, however, that approach is far too simplistic and needs to be substantially refined. As an initial matter, it is necessary to separate the analysis of accountants from attorneys. While it is clear that the mere error in judgment rule applies to attorneys and its application is said to be universal, application of the mere error in judgment rule to accountants might be more problematic. The source of the problem is that I have been unable to locate any case law that applies the mere error in judgment rule to accountants. While I acknowledge the possibility, or even the likelihood, that I might have missed a case or two, nevertheless, there certainly seems to be nothing even close to what could be

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77 Id. at 777.
78 Id. at 775.
79 Id. (quoting 7 Am. Jur. 2d Attorneys at Law section 201 (1980)).
81 668 N.E. 2d 799 (Mass. 1996). See also Pytlak v. Gatsby Hannah, LLP, 15 Mass. L. Rep. 451, 2002 WL 31862712 at *10 (Super. Ct. 2002). In Williams, counsel opined that there would not be any estate or gift tax liability if the taxpayer disclaimed his contingent interests in family trusts in 1975, regardless of the fact that the taxpayer had known of those interests for many years. Id. at 802.
82 Id. at 802.
83 Mallen and Smith, supra note 5, section 18.1 at 2. See also Blair v. Ing, supra section 18.1 at 2. See also Proctor v. Adams, supra at 806. In reality, the answer depended on whether the time for making a disclaimer commenced (a) when the holder of the contingent interest first learned of the existence of the interest or (b) when the interest vested. When the opinion was rendered there were two Tax Court opinions holding that the time to disclaim commenced when the holder of the interest first learned of the existence of the interest and one opinion of the Eighth Circuit reversing the Tax Court and holding the other way. See id. at 802-03. The attorney’s definitive answer failed to inform the taxpayer that the IRS was free to relegate the issue in another circuit and that a conflict between circuits might prompt the Supreme Court to grant certiorari and perhaps overrule the case on which counsel was relying, which is exactly what occurred. See id.
84 Id. at 806.
85 589 N.W.2d 103 (Neb. 1999).
86 Id. at 806.
87 See 3 Mallin and Smith, supra note 5, section 18.1 at 2.
88 Id. at 802.
89 Id. at 806.
90 Id. at 802.
91 See Martinson, supra note 72 at 775 (quoting 7 Am. Jur. 2d Attorneys at Law section 201 (1980)).
92 See 3 Mallin and Smith, supra note 5, section 18.1 at 2.
93 Id. at 806.
characterized as a line of cases applying the mere error in judgment rule to accountants. The leading commentators in their treatise, Standards of Tax Practice do equate accountants and lawyers and indicate that the mere error in judgment rule applies to both professions. The logic underlying the mere error in judgment rule would seem to apply equally to accountants as well as to attorneys and there are many cases that hold the elements of a malpractice action are substantially identical regardless of whether the defendant is an accountant or an attorney. However, the absence of case law applying the mere error in judgment rule to accountants is of concern.

Assuming the mere error in judgment rule does apply to accountants, there are still aspects of the accountants’ role in our situation that might make the rule inapplicable. First, there was a conflict between the accountants’ more-likely-than-not written opinion and their unhedged oral statement that the FLIP works and is “bullet proof.” If the plaintiffs could prove the oral statements, then, perhaps, liability could not be avoided under a Williams v. Ely approach, because the options available under the law could no longer be said to have been adequately disclosed. And, perhaps even under the general mere error in judgment rule, the inconsistent advice might prevent its applicability.

The second reason why the mere error in judgment rule might not apply here is that the accountants wore several different hats in our transaction. In addition to simply rendering a professional judgment on a tax question, they also acted either as principals selling the tax shelter (if one assumes they put the deal together and inserted the financial intermediate for appearance sake) or else they were active sellers or agents of the promoter of the tax shelter (if, as seems unlikely, the financial intermediaries were truly independent). While the mere error in judgment rule might protect the accountants in their adviser role, it certainly would not extend to protect them in any of their other roles. Thus, liability could easily be found under some other cause of action, such as fraud or violation of the securities law. Closely related, since the accountants played many roles in the transaction, some of which would raise conflict of interest issues (their role as adviser obviously conflicted with their role as sellers of the FLIP), unless the conflict of interest was adequately disclosed (or perhaps patently obvious), malpractice liability would be incurred outside the protective realm of the mere error in judgment rule.

As to the attorneys’ situation, if the attorneys were simply acting as advisers who examined a proposed transaction in an unsettled or unclear area of tax law and rendered a more-likely-than-not opinion, they would seem to be able to avoid liability under the basic mere error in judgment rule. Similarly, if their opinion was well-crafted and described the inherent uncertainty and the various possibilities they would seem to also be able to avoid liability under the Williams v. Ely approach because the various legal options were disclosed to the client.

However, even regarding the attorneys, further facts are necessary. While under our hypothetical facts the attorneys seem to be acting solely as advisers, there are other shelter schemes in which the attorneys were actually the promoters of the shelter, much the same as KPMG was in the FLIP situation discussed above. As such, they would face the same additional liability exposure as the accountants above, apart from any malpractice exposure. Similarly, in our hypothetical fact pattern, if the attorneys had some understanding or arrangement with the accountants under which it was understood that they would render opinions that would help sell the FLIP transactions, they should not be protected by the mere error in judgment rule because, at the very least, they had an undisclosed conflict of interest, or else they might even have become like sellers of the shelter.

While highly improbable, another possibility exists regarding the attorneys. That possibility would assume that there was no understanding or arrangement between the accountant promoters of the shelter and the attorneys. Instead, it assumes an early offeree of the FLIP transaction simply obtained the attorneys’ independent opinion of the transaction and received the more-likely-than-not opinion. Knowing that those attorneys would render an opinion that the FLIP transaction was viable, the accountants simply kept referring new potential shelter investors back to the same attorneys for identical opinions on the same FLIP transaction. As such, if the mere error in judgment rule would insulate the attorneys from liability on the initial opinion perhaps it should also apply to later repetitions. But, at some point, should not the attorneys be charged with recognizing that they are being used to market the shelter?

While it might seem very distasteful to exonerate tax advisers from malpractice liability when they were overly aggressive and ignored real risks simply because the underlying area was unclear or unsettled, this result might occur under the mere error in judgment rule. Of course, liability might still be imposed on other grounds, such as fraud or under the securities laws, when the attorney or accountant had more involvement than simply acting as an independent adviser as to tax consequences.

III. Second Obstacle: Statute of Limitations

Whenever any litigation is commenced one of the threshold issues is whether the suit is timely and not barred by the relevant statute of limitations. Those considerations also apply in any malpractice litigation against the tax adviser involved in our bad tax shelter situation. However, determining the governing statute of limitation and when it commences to run in our situation might be quite problematic.

As an initial matter, the actors involved in our hypothetical situation might very likely reside or be domiciled in different states and a determination will be required as

90 Wolfman et al., supra note 5.
91 Id., section 603.5 at 453. Interestingly, the cases cited to illustrate the mere error in judgment rule all involve attorneys.
92 See, e.g., Hnath v. Vecchitto, supra note 46 at 22. See generally Malpractice I, supra note 5 at 547, 551 note 13.
93 See, e.g., Seippel v. Jenkins & Gilchrist, supra note 6.
to which state’s statute of limitations governs and how long that statute is.\textsuperscript{94} Also, it would be necessary to determine when the various potentially relevant statutes commence to run because there are many views prevalent among the various states as to when the statute of limitations commences to run in tax malpractice situations.\textsuperscript{95} As a starting point, there seem to be four different conceptualizations as to when the statute of limitations begins to run:

1. when the malpractice occurs;\textsuperscript{96}
2. when the malpractice is discovered, or, with reasonable diligence, discoverable;\textsuperscript{97}
3. when an injury is suffered;\textsuperscript{98} and
4. when the injury is discovered, or with reasonable diligence, discoverable.\textsuperscript{99}

Also, even when states purport to follow the same conceptualization, they often apply it differently. For instance, in New York, which follows the occurrence rule, the malpractice as deemed to occur, and the statute of limitations begins to run, when the client receives the tax practitioner’s work product.\textsuperscript{100} Applying Indiana law, a federal court held that the statute begins to run either on the date the taxpayer filed the negligently prepared tax return with the IRS or the date the taxpayer paid the tax practitioner.\textsuperscript{101} Similarly, when the discovery of injury rule differs as to whether it means the variation amongore is so great that the statute of limitations can commence as early as when the faulty tax advice is given\textsuperscript{106} and as late as when a final settlement is reached with the IRS\textsuperscript{107} or even after litigation is completed,\textsuperscript{108} a span that could easily cover many years. That variation among the states becomes even more pronounced in light of the fact that some states may allow the statute of limitations to be tolled when there is fraudulent concealment of the malpractice by the tax practitioner;\textsuperscript{109} or when there is continuous representation by the tax practitioner of the taxpayer regarding the specific matter involved.\textsuperscript{110} Adding yet another layer of complexity to determining the correct statute of limitations and its commencement date is that it is necessary to also consider the choice of law rules of the various possible forum states to correctly predict which state’s law ultimately will be applied.

Late in 1999, Ernst & Young convinced Mr. Seippel to engage in a COBRA tax shelter transaction involving the purchase and sale of options on foreign currency to shield his $12 million gain from taxation.\textsuperscript{112} According to the complaint, Ernst & Young convinced Mr. Seippel that the COBRA shelter was completely legal and even conservative.\textsuperscript{113} He was informed by Ernst & Young that it

\begin{quote}
The variation among states is so great that limitations can commence as early as when the faulty tax advice is given and as late as when a final settlement is reached with the IRS or even after litigation is completed.
\end{quote}

\textsuperscript{95}Compare Rule, supra note 62 at 179, who has different categories.
\textsuperscript{100}Ackerman v. Price Waterhouse, supra note 96 at 541.
\textsuperscript{101}Davis v. Geo. S. Olive Co., supra note 98 at 1386-87.
\textsuperscript{103}See, e.g., Cameron v. Montgomery, 225 N.W.2d 154 (Iowa 1975).
\textsuperscript{104}See, e.g., Wall v. Lewis, 366 N.W.2d 471 (N.D. 1985).
\textsuperscript{105}See, e.g., Murphy v. Campbell, 964 S.W.2d 265 (Tex. 1997) (no bright-line rule).
\textsuperscript{106}See, e.g., Ackerman v. Price Waterhouse, supra note 96.
\textsuperscript{108}See, e.g., Peat, Marwick, Mitchell & Co. v. Lane, 565 So.2d 1323 (Fla. 1990).
\textsuperscript{109}See generally Rule, supra note 62 at 183; Annot., supra note 94 at 950.
\textsuperscript{110}See generally Rule, supra note 62 at 182; Annot., supra note 94 at 955.
\textsuperscript{111}Supra note 6.
\textsuperscript{112}Id. at 368-69. “COBRA” is an acronym for Currency Options Bring Reward Alternatives. Id. at 367.
\textsuperscript{113}Id. at 369.
had developed the COBRA shelter and that two blue-chip law firms, Jenkens & Gilchrist and Brown & Wood, would provide opinion letters as to the propriety of the COBRA transaction.

From the opinion it appears that the various steps of the COBRA transaction were effectuated during December 1999. Defendant Deutsche Bank was used to effectuate some of the transactions. In February 2000 Mr. Seippel received an opinion letter from Jenkens & Gilchrist stating that the $12 million of losses generated by the COBRA transactions were legally deductible. A similar opinion was received from Brown & Wood in March 2000 that also indicated that the IRS should not be able to successfully assert any penalties as a result of the tax positions taken by Mr. Seippel in the COBRA transactions. Ernst & Young prepared the 1999 and 2000 tax returns for Mr. and Mrs. Seippel reporting the COBRA transactions.

While the Sommerville holding is not surprising, the dates involved are quite noteworthy. Sommerville is a straggler from an earlier generation of tax shelters.

In March 2002 Ernst & Young informed Mr. Seippel that it had received subpoenas in connection with an IRS investigation of COBRA. Mr. Seippel retained new tax and legal advisers in July 2002 and then discovered the alleged fraud. The present suit was brought on September 10, 2003.

According to the complaint, the attorney defendants, Jenkens & Gilchrist and Brown & Wood, actually developed and promoted the COBRA shelter as well as many other tax shelters. They had Ernst & Young assert that it had developed the shelter to give the impression that the attorneys were exercising independent judgment in rendering their opinions. That also enabled both attorneys to charge substantial fees for what were essentially "canned" opinions requiring little, if any, additional work. Also, Ernst & Young allegedly over-represented the positives of the shelter (it was "100 percent legitimate") while failing to disclose authority to the contrary.

As a result of the defendants’ actions in blessing, and putting Mr. Seippel into, the COBRA tax shelter, which the defendants knew or should have known would not be accepted by either the IRS or the Virginia tax authorities, Seippel claimed the following damages: (1) fees paid to advisers retained to rectify the harm caused by the defendants’ wrongdoings; (2) payment of more than $5 million in additional taxes he was promised would not have to be paid; (3) payment of interest and penalties of more than $1 million; (4) losses caused by having to liquidate assets at "fire sale prices" to meet their tax obligations; and (5) the loss of alternative legitimate tax savings. He also sought recovery of the fees paid to the defendants.

While the plaintiff’s case seems very compelling, the malpractice cause of action was dismissed on statute of limitations grounds, due entirely to the unfortunate fact the suit was brought in New York rather than in Virginia. In deciding the motion to dismiss the malpractice claims on statute of limitations grounds, the district court’s starting point was that a federal court sitting in New York must apply New York’s choice-of-law rules and its statute of limitations when jurisdiction is based on diversity of citizenship. Under New York’s borrowing statute, when a plaintiff who is a non-New-York resident sues based on a cause of action that accrued outside New York, the court must apply the shorter limitation period of either New York or the state where the cause of action accrued. In Seippel, under New York law, the place of injury was deemed to be Virginia, where the Seippels resided. Under Virginia law, the relevant statute of limitations for legal malpractice is five years and this case, according to the district court, is clearly timely under Virginia’s statute of limitations. However, because the relevant New York statute of three years is shorter, its shorter statute must be applied. Unfortunately for the plaintiff, the New York statute accrues "when all the facts necessary to the cause of action have occurred and an injured party can obtain relief in court.... The claim accrues ‘even if the aggrieved party is then ignorant of the wrong or injury,’" Similarly, according to the court, New York does not recognize tolling of the statute of limitations in non-medical-malpractice cases,

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114Id.
115Id. at 370.
116Id.
117Id. at 366.
118Although the Jenkins & Gilchrist defendants were important participants in the events in issue, all claims against them were stayed, and only the other defendants participated in those proceedings. Id. at note 2.
119Id. at 367, 378-79.
120Id. at 367-68.
121Id. at 368, 379.
122Id. at 370.
123Id. at 380.
124The plaintiffs also asserted causes of action for negligent misrepresentation, breach of fiduciary duty, and breach of contract, among others. But the court held that those claims were duplicative of, and merged into, the malpractice claim. Id. at 376-77.
125Id. at 374.
126Id.
127Id. at 374-75.
128Id. at 375.
129Id.
130Id., citing Ackerman v. Price Waterhouse, supra note 96.
131Id.
even for fraudulent concealment. According to the court, for New York statute of limitations purposes the plaintiffs’ cause of action accrued against Brown & Wood "on or about March 9, 2000 when the plaintiffs received and relied on Brown & Wood’s opinion letter." Because the case was brought on September 10, 2003, it was untimely under New York’s statute of limitations.

In an ironic twist, in Seippel the district court initially dismissed the malpractice claims on statute of limitations grounds but granted the plaintiff’s request for leave to refile elsewhere in a jurisdiction where the claims would not be time-barred. However, later, in response to a motion by the defendants for reconsideration of that aspect of the original opinion, the court granted the defendants’ motion and held the dismissal was with prejudice and that the plaintiff was precluded from refiling the claims elsewhere. The reason for the change of heart was that under New York law a judgment dismissing a claim as time-barred is treated as a judgment on the merits for res judicata purposes with full preclusive effect. Accordingly, even if the claim were refiled elsewhere the other court would be required to apply New York’s preclusion rules and dismiss the claim on the basis of res judicata. On its reconsideration, the court was poignantly cognizant of the fact that the Seippel claim would have been timely if brought originally in Virginia rather than in a court applying New York’s borrowing statute and that the result seems harsh. The court nevertheless decided the result was justified by important policy concerns to prevent forum shopping and to prevent a plaintiff from having a second chance elsewhere once a New York court decides a claim is time-barred.

The vexatiousness of statute of limitations issues is aptly illustrated by Sommerville v. Hochman, Salkin and DeRoy. In Sommerville, the California Court of Appeals recently reversed the trial court’s award of summary judgment on statute of limitations grounds to the defendant attorneys in a tax malpractice situation not very different from the one focused on in this report and remanded the case for trial to determine when the plaintiff investors discovered the malpractice and whether the statute of limitations was tolled by the continuous representation doctrine. While the Sommerville holding is not surprising, the dates involved are quite noteworthy. The case was initially filed in June 1993 and the facts occurred in 1980 to 1982 — nearly a quarter century ago. Sommerville is a straggler from an earlier generation of tax shelters. It involves a malpractice suit arising out of investments in a commodities straddle tax shelter, a type of shelter popular in the late 1970s and early 1980s. While the facts of Sommerville are not especially germane to our situation, a brief glimpse at the above chronology of its events (see chart above) might lead an observer to conclude that a similar time frame could easily occur in litigation over the current generation of tax shelters.

133 Id. at 375.
134 Id. at 386.
136 Id. at *6.
137 Id. at *6-7.
138 Id. at *9.

140 Id. at *2.
IV. (Possible) Third Obstacle: No Damages Yet

In *Loftin*, discussed above, the court dismissed all state causes of action, including those for malpractice, on the grounds they were unripe because the court deemed the plaintiff to have not yet suffered any damages since the IRS had not yet assessed any additional amounts. Loftin’s allegations that he was committed to settling with the IRS and would likely have to pay substantial additional taxes, interest, and probably also penalties were held to be inadequate to withstand the motion to dismiss. Without alleging the incurrence of any actual damages, the court held that the case was unripe and the plaintiff therefore lacked standing to bring the asserted claims.\(^\text{141}\)

As an initial matter, the court’s holding that no damages were alleged to result from the defendant’s actions seems counterintuitive. The plaintiffs clearly incurred needless legal fees and transaction costs as well as additional professional costs for representation during the audit and settlement negotiations with the IRS. Those seem to be recoverable damages.\(^\text{142}\) Perhaps the result might be justifiable if the pleadings were defective and contained no clear allegations of those damages. However, in any event, the court’s treatment of Loftin’s allegations that he was committed to paying substantial additional taxes, interest, and probably penalties might turn out to be very problematic.

In its analysis of this issue the court stated: \(^\text{143}\)

> Loftin argues that he has suffered an injury because he has committed to settle with the IRS and is just waiting to be told the ultimate number! ... Loftin speculates that he will have to pay the IRS a ‘hefty sum’ as a settlement. ... Until and unless Loftin and the IRS reach a final resolution of the dispute, it is impossible to determine whether Loftin actually suffered damages from Defendants’ alleged misconduct. Even if Loftin is anticipating having to make a large payment to the IRS, the amount and nature [emphasis in original] of the payment remain unknown. Indeed, if Loftin’s settlement payment amounts to nothing more than payment for back taxes and interest, he will not have suffered an injury. ... [emphasis added]

The problem with the court’s analysis is that the court seems to be holding as a matter of law that the payment of back taxes and interest might never be recoverable as damages in tax malpractice actions.\(^\text{144}\) Similarly, as indicated at the beginning of this article in the brief review of damages recoverable in tax malpractice actions, regarding the recovery of interest as damages there are three views: Some states do not permit the recovery of interest as damages; other states do permit the recovery of interest as damages; while a third view permits the recovery of interest only to the extent of the difference between interest paid to the IRS and interest actually earned by the taxpayer on the money.\(^\text{145}\)

If the court was simply intending to state that under the facts of *Loftin* the relevant state law\(^\text{146}\) would treat the payment of the back taxes and interest as nonrecoverable, the holding might not be especially troublesome, or significant. However, the court did not seem to be doing that. Regarding all of the asserted state causes of action, the court was very careful to analyze the elements of the respective causes of action under the laws of both states whose law might govern (Florida and North Carolina) or to indicate that their laws were substantially the same.\(^\text{147}\) However, the court made no reference to state law regarding back taxes and interest. It just assumed as a universal truth the incorrect proposition that back taxes and interest might never be recoverable as damages in tax malpractice actions.

V. Conclusion

Under our legal system, when one incurs damages as a result of negligent advice received from an attorney or accountant, one can reasonably expect to be able to obtain recompense from the errant adviser. While that proposition is generally correct, when the advice concerns investment in a tax shelter the mere error in judgment and the statute of limitations might present substantial obstacles to obtaining such a recovery. While the mere error in judgment rule should not protect a tax adviser who acted as a promoter of the shelter, it might very well protect a nonpromoter tax adviser who took an overly aggressive position because the law relevant to tax shelters certainly “has not been settled by a court of last resort” and is likely an area “on which reasonable doubt may well be entertained by informed lawyers.”\(^\text{148}\) While leading authorities indicate the mere error in judgment rule applies to accountants as well as attorneys and the logic for such a rule is appealing, I am still somewhat doubtful in view of the dearth, if not the absence, of relevant case law.

Similarly, as the *Seippel* case illustrates, correctly determining which state’s statute of limitations governs, when the statute accrues, and in which forum to bring the action is not easy. A wrong decision will certainly present an obstacle to any recovery. The determination might become even more difficult if some forums are desirable.
from the vantage of other causes of action asserted against the tax advisers or other defendants, although they are undesirable, or not optimal, concerning the statute of limitations.

Finally, whether the comments by the court in *Seippel* concerning back taxes and interest will create yet another obstacle to obtaining a recovery for the damages resulting from an investment in a bad tax shelter will depend on how the enigmatic language of the court is construed. If the language is narrowly construed to simply reflect the court’s conclusion as to the particular facts *sub judice* under the laws of the relevant state or states, the effect of the language should be minimal, except perhaps for cases arising in those states. If the language is more broadly construed as a finding of what is the current state of the law in general, it is certainly much more troublesome.