Accountants' Liability Tip

Avoiding Liability: Business Client Tax Extensions and Engagement Letters

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Introduction

Most sophisticated accounting firms are good at getting engagement letters signed before performing core audit, tax or advisory services. What about situations where core services are to be performed later, as is the case where a client needs an extension of time to file tax returns? Unfortunately, many accountants do not get engagement letters in place before filing tax extensions, instead waiting until the tax returns are ready to be prepared. This creates unnecessary risk and potentially increases liability.

Scenario

A business client needs an extension of time to file its tax returns. The accounting firm prepares the Form 7004 Application for Automatic Extension and forwards it to the client for review. However, due to a breakdown in communication, neither the client nor the accountant files the extension.

Months later, the accountant and client execute an engagement letter for preparation of the tax returns. The standard engagement letter contains a provision limiting the accounting firm's liability to the fee paid.

The final tax returns seek a tax benefit for prior net operating losses. The IRS rejects the returns as untimely and denies the tax benefit sought. The client then sues the accounting firm, who claims that the engagement letter limits the firm's liability to the fee paid for the tax preparation.

At least one Court presented with this scenario has found that the engagement letter did not limit liability because: (1) it was executed five months after the alleged failure to file the extension; and (2) the scope of work referenced only the preparation of the tax returns, not the extension request. The Court went on to hold that the engagement letter did not provide for releases or limitations of liability for services beyond the scope of the engagement letter or for conduct that already occurred. Instead of facing a claim for several thousand dollars, the accounting firm found itself defending a multi-million-dollar claim.

Steps to Mitigate

Accounting firms can mitigate their risk of liability in this scenario by:

(1) requiring that engagement letters are executed before commencement of any new services, even if those services are seemingly administrative, like filing an application for automatic extension to file taxes;

(2) reviewing engagement letters to ensure that any related services (like preparation and filing of an application for extension) are specifically included in the scope of the engagement letter, and that the releases and limitations of liability provisions apply to conduct that has already occurred; and

(3) communicating with clients in a clear manner the party responsible to prepare, review and file documents.

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