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The Professional Lines ALERT

Accounting Malpractice Claim Time-Barred By Two-Year Statute of Limitations

March 15, 2011

SK Partners I, LP, et al. v. Metro Consultants, Inc., ___ Ill. App. 3d ___, ___ N.E.2d ___, 2011 WL 636941 (1st Dist. 2011)

Brief Summary

An Illinois court held that plaintiffs' malpractice action was barred by the two-year statute of limitations, and rejected plaintiffs' reliance on the "discovery rule" to extend the time.

Complete Summary

Plaintiff partnerships, which were related entities, retained defendant, a first accounting firm, to provide accounting services for the purpose of filing income taxes. The first accounting firm prepared the partnerships' income tax returns for the tax years of 2000–2002. Its accounting services were last used on or before April 15, 2003, and the partnerships subsequently retained a second accounting firm.

An accountant with the second accounting firm testified that he reviewed the partnerships' previous years' tax returns and that in October 2003, "it appeared something wasn't correct about [the] basis." He believed there were inconsistencies in the previous tax documents, which caused the tax returns to overstate income, resulting in greater tax liability for the partnerships. The second firm's accountant believed that the initial mistake occurred in 1999 and was carried through 2000 to 2002, which essentially comprised the time span that the first accounting firm prepared the partnerships' tax returns. In November 2003, he informed the trustee of one of the partnerships that it could take up to a year to properly investigate the issue and file amended tax returns. An amended tax return was filed on September 11, 2004 for one of the partnerships; amended returns for the other entities were filed in October 2004.

The Internal Revenue Service (IRS) conducted an audit after receiving the amended tax returns and subsequently issued a series of refund checks, the first being issued on December 13, 2004, and the last on April 21, 2006. The partnerships filed their accounting malpractice action on September 21, 2006. The trial court granted a motion to dismiss based on the two-year statute of limitations.

On appeal, the appellate court initially noted that the applicable statute of limitations was controlled by 735 ILCS 5/13-214.2(a) (2006), which provides that an accounting malpractice action must be commenced within two years from the time the person bringing an action knew or should reasonably have known of such act or omission. The partnerships first argued that the trial court erred in relying on

Dancor International, Ltd. v. Friedman, Goldberg & Mintz, 288 Ill. App. 3d 666, 672 (1997) in dismissing the claim. In *Dancor*, the court held:

> The discovery rule has never been interpreted to delay commencement of the statute of limitations until a person acquires actual knowledge of negligent conduct. Rather, it has been interpreted to delay commencement until the person has a reasonable belief that the injury was caused by wrongful conduct, thereby creating an obligation to inquire further on that issue.

The partnerships argued that it was not until December 13, 2004, when the first refund check was issued to them by the IRS, that the statute of limitations began to run, because that was the date that they had actual knowledge of damages. The court disagreed, finding that Illinois courts have consistently held that under the discovery rule, a statute of limitations may run despite the lack of actual knowledge of negligent conduct. The court recently considered the same statute of limitations in an accounting malpractice situation where tax deficiencies, i.e., an underpayment of taxes, were first found by the IRS. *Federated Industries, Inc. v. Reisin,* 402 Ill. App. 3d 23 (2010). The *Federated Industries* court adopted the rule that "the statute of limitations in an accountant malpractice case involving increased tax liability begins to run when the taxpayer receives the statutory notice of deficiency . . . or at the time when the taxpayer agrees with the IRS' proposed deficiency assessments." The partnerships urged the court to adopt a similar rule in the case before it, arguing that the statute of limitations did not trigger until the IRS determined that their previous tax returns were calculated incorrectly and issued a refund.

The court noted that this case was clearly distinguishable because it did not involve a tax *deficiency*, but rather an *overpayment* of taxes first noticed by a different accountant. The court found, however, that *Federated Industries* provided helpful guidance and noted that while the rule in that case did not readily apply to situations of tax overpayments, its underlying rationale for determining the commencement of the actual injury was compelling.

The partnerships argued that they "did not have actual damages when the second firm's accountant filed the amended tax returns, but instead sustained actual damages when the IRS accepted the amended tax returns and made the first refund." The court concluded, however, that the partnerships relied on understated depreciation figures calculated by a previous accountant and used those figures in filing their subsequent tax returns. It held that actual damages logically occurred at the moment taxes were overpaid. Applying this same logic to cases where taxes are underpaid, the court noted that it would also conclude that there are no actual damages until a deficiency is assessed. In such cases, negligent conduct may have occurred upon the preparation of the tax return, but the taxpayer actually retains more income than allowed and has not suffered actual damages yet. An overpayment of taxes, however, immediately deprives the taxpayer of income. The court thus rejected the partnerships' assertion that damages were not incurred until they received a refund.

The court held that the partnerships had to be charged, at the latest, with a reasonable belief of any overpayment by September 11, 2004, when an amended tax return was filed. By then, it was plainly obvious there was a tax overpayment. The court thus held that the statute of limitations expired at the latest by September 11, 2006.

Significance of Opinion

In cases involving a tax overpayment, damages occur immediately upon the overpayment. The issue is determining when the overpayment was discovered such that the plaintiff had a reasonable belief that the injury was caused by "wrongful conduct."

For further information, please contact Terrence A. McAvoy or your regular Hinshaw attorney.
