Tax engagement letters

Use of this important practice tool can minimize professional liability risk, reduce confusion, improve collections, and ensure clients have a good understanding of the practitioner's role.

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Although tax engagement letters are often the topic of discussion in professional journals and presentations, in many situations CPAs neglect to use this tax management tool. As a result, the importance of reviewing this method to reach an understanding with clients is always relevant. Every CPA (and client) needs to know what is expected of both parties in a professional engagement.

CPAs are frequently reminded by their malpractice carriers to issue engagement letters and request that their clients read them and indicate they understand and accept their terms. In professional liability litigation, the first question the defense attorney asks is usually, "Did you have an engagement letter?" To help reduce malpractice claims, many professional liability insurance carriers present free risk management seminars, and some offer premium discounts for clients who attend. Most of these seminars specifically cover tax services engagement letters. This article examines whether engagement letters are contracts. In addition, it addresses some common criteria that should be considered and terms that should be included in most engagement letters.

CONTRACTUAL STATUS OF ENGAGEMENT LETTERS

An "engagement letter" is not a "contract"—or is it? An engagement letter can form a basis for an enforceable contract (see "Engagement Letters for the Individual Tax Practitioner," JofA, Jan. 2014, page 32). However, even if a court concludes that the engagement letter is a contract, only certain terms may become the subject of a malpractice suit. In the cases cited below (Apple Bank for Savings v. PricewaterhouseCoopers, 18 Misc. 3d 1137(A) (N.Y. Sup. Ct. 2008), rev'd, 895 N.Y.S.2d 361 (N.Y. App. Div. 2010), and Tayebi v. KPMG, 18 Misc. 3d 1139(A) (N.Y. Sup. Ct. 2008)), the engagement letters were examined to determine whether New York state's statute of limitation on malpractice claims had expired. These rulings reinforce the importance of careful wording delineating the period for which the services are being rendered as well as the importance of having an attorney review the engagement letter template.

Regardless of whether engagement letters are contracts, they serve the important function of communicating with the client, from the accountant's perspective, the professional work to be performed, the terms and conditions of performing that work, any limitations on that work, and what the accountant expects from the client, including the terms and conditions for payment.
The engagement letter can also promote services related to the subject matter that are beyond the scope of the engagement and for which the accountant has not in fact been engaged.

Mentioning other services that are available strongly implies that these services are not a part of the present engagement as the CPA understands it. A provision excluding all other services except those specifically described should effectively limit the scope of services.

The need to solicit the client’s understanding of, and agreement to, the terms of an engagement letter cannot be overemphasized. All concerned parties should understand each party’s expectation of who is responsible to complete the task at hand. All aspects should be included.

If a formal tax engagement proposal was submitted to the client, the specific obligations usually have already been stated, and the engagement letter operates as an acceptance, with any changes noted, to the terms of the proposal. For this reason, the terms presented in the formal proposal should be reviewed in conjunction with the drafting of the tax engagement letter to reduce any potential misunderstandings. While a proposal can be promotional, such as discussing how competent the CPA is, how timely the CPA's services are, and other laudatory ideas, the engagement letter should stick to objective criteria. These promotional claims may be useful marketing tools during the engagement proposal process, but they should not be part of or a substitute for an engagement letter.

Professional liability claims are often based on procedural errors, such as late filings or missed elections (e.g., partnership basis step-ups or S elections), but, in the author's experience, these responsibilities are often not specified, but only implied in the engagement letter. Obviously, the parties should agree on these responsibilities if they are to become, or could become, part of the engagement. For example, in a compliance engagement, someone must agree to actually file the completed return.

The engagement letter should specify whether the CPA engaged to prepare a tax return also will file it for the client or whether the client will be responsible, even though in most cases the client will be required to sign the form before it is filed. If the CPA will be filing the return (e.g., electronically), it is implied that the filing will be timely. When a new corporation that will elect S status is formed, it should be clear whether the CPA, the attorney, or the client will file Form 2553, *Election by a Small Business Corporation*, and that it will be done timely.

In some engagements, the practitioner specifically undertakes to do some procedural task, such as file an election to be taxed as an S corporation, on the client's behalf. Thus, it is crucial that the letter include specific procedural undertakings and who, if anyone, is responsible for performing those tasks. If the procedural task will not be specifically undertaken, it could be included in the listing of additional services not being performed under the agreement that is available if requested.
What should be included in engagement letters is discussed in detail below.

IDENTIFY THE CLIENT

It is critical to specifically identify the client or clients. Sometimes in a tax engagement, any number of entities—corporations or limited liability companies (LLCs)—can be affiliated with one another. In addition, the owners of closely held entities often expect personal tax services as well as services for their companies. A listing of all entities and any individuals involved in the work requested can prevent misunderstandings. Another option would be to have separate engagement letters for each entity. After all parties to the engagement are considered, the balance of the terms and conditions of the engagement letter are easier to describe. If, in the course of the engagement, additional entities are discovered that may be related to the subject matter, discussions with the client representative should be held to determine whether the new entity should be included and whether the existing engagement letter should be modified or a new engagement letter is needed. In addition, during the engagement, underlying factual changes may necessitate reconsidering the original terms of the engagement letter. For example, if a single-member LLC, which is a disregarded entity, has evolved into a multimember LLC, a separate return would probably be required, possibly requiring separating the transactions that have been commingled with the parent company.

PERIOD COVERED

Whenever possible, open-ended engagements should be avoided because they create uncertainty. A properly drafted engagement letter should specify the time frame covered and the scope of services to be provided. Specifying a one-year time period is often advisable because it keeps the practitioner from being responsible for filing tax returns in future years.

Engagement letters that fail to specify the time period create problems with determining the scope as well as other items, such as billing. The usual expectation and hope is that clients will prosper and, thus, increase over time both the scope and the complexity of their tax-related business concerns. This, in turn, should change the scope of the services to be rendered in the time frame from those included in the initial engagement letter. Therefore, it is important to reconsider every year the changes in the client’s business and the changes in the client’s professional needs. Failure to properly monitor these may result in “engagement creep,” in which the initial engagement letter becomes disconnected from the client’s current professional needs.

In Apple Bank for Savings, a bank filed a lawsuit alleging it received improper tax advice relating to stock buybacks. An engagement letter the bank produced specified the tax years for return preparation, but the period for which PwC would perform “recurring tax consulting services” was not specified, thus leaving the consulting time period open-ended. Under New York law, a suit alleging professional malpractice was required to be filed within three years of the termination of the engagement. PwC claimed the engagement terminated upon delivery of the tax returns. The court found that because
PwC continued, by preparing the bank’s tax returns for subsequent tax years, to advise the bank about the issue for which advice was rendered, there was continuous representation, which prevented the running of the three-year statute of limitation from the date the tax return was delivered.

The N.Y. Supreme Court Appellate Division, however, overturned the trial court's ruling, stating that the trial court "erred in finding that the statute of limitations was tolled under the continuous representation doctrine." The court went on to say that PwC "never had any express, mutual agreement to advise plaintiff on the effect of the stock buyback, after the original advice." Nonetheless, the case illustrates the contentious and expensive litigation that can result when an engagement letter is vague about the scope and time frame of services.

In *Tayebi*, the court reached the opposite conclusion. In that case, the period covered by the opinion letter about a tax shelter was left open, and KPMG claimed that the delivery of an opinion letter ended the engagement. The engagement letter stated that "unless you specifically engage [KPMG] to do so in writing, we will not update our advice for subsequent changes or modifications to the law and regulations."

Ruling in favor of client Sean Tayebi’s continuous representation argument, the court stated that the engagement letter included language "indicating that the parties may have contemplated further services" pertaining to the tax shelter transaction that were the subject matter of the lawsuit. The court determined that "it was only as to updates about changes in the laws and regulations that KPMG was excluding from its future services," and the language "hardly indicates an intent by KPMG to dissociate from plaintiffs’ future transactions. Therefore, the engagement constituted "continuous representation" for other services. It is very important to state specifically the time periods for which services are being rendered and the point at which the engagement is concluded.

**EXPECTED CLIENT RESPONSIBILITIES**

The engagement letter should not only express the CPA's obligations in performing tax services, but it should also describe the information that the CPA can expect the client to supply. The engagement letter can set out the details (e.g., statements of wages, interest, and dividends, and securities brokerage statements) of specific information and data sources that are needed. If the CPA uses tax organizers, the letter should include the expected completion date. For a business entity, the list of possible data sources usually includes general ledgers, journals, bank statements, property acquisitions and dispositions, and depreciation schedules.

To meet filing deadlines for tax returns and other services, a timetable for clients to provide information should be included in this section. This should also include alternatives if clients don’t meet these schedules, such as the filing of tax return extension requests. Listing these obligations emphasizes that the client's active participation is essential for the CPA to timely complete the engagement.
RELIANCE ON CLIENT RECORDS AND ASSURANCES

In the engagement letter, the CPA should specify that he or she will rely on the client’s records to prepare the tax return or perform other services. Clients should be informed that client records are usually accepted at face value, and that their accuracy is the clients’ responsibility. CPAs are not obligated to detect fraud or malfeasance. While clients should be able to rely on their CPA to apply the tax laws, the engagement letter should affirmatively state that clients are responsible for providing accurate information.

SCOPE OF SERVICES

When properly drafted, engagement letters are considered contracts, so certain provisions within the engagement letter may be referred to in litigation over a client’s (or most likely a former client’s) claim of malpractice. The scope of services to be provided is one area that is particularly relevant in a lawsuit. The plaintiff would likely argue that the particular services were covered in the scope of services specified in the engagement letter, while the CPA would likely claim that he or she was not engaged to perform the service that the plaintiff alleges was either omitted or performed incorrectly.

Not all services that might eventually be performed can be anticipated at the commencement of an engagement. It may become necessary to address the need to prepare additional related-party tax returns, delinquent returns, and payroll and property tax returns. In these cases, CPAs should be vigilant in recognizing whether addendums or revisions are needed or whether a new engagement letter may need to be prepared. Continuously comparing the services being rendered to those specified in the original engagement letter can greatly improve the management of the engagement.

As previously pointed out, not only is it important to describe what services will be performed, but also which services will give rise to additional fees so the client cannot claim that a particular service was included under the terms of the engagement letter. Since the CPA has significantly more knowledge about and experience with the scope of a tax engagement, it is reasonable that the CPA would have the burden of considering these details.

An engagement letter should also describe limits on services that may be required if conflicts of interest arise. A good knowledge of the client’s business can help with determining which items should be included. All limitations should be described, including that the CPA is not expected to detect fraud and may take the client’s representations at face value. If there is any missing information of which the client is aware, it should be documented in the engagement letter so that the client acknowledges these limitations.

FEE ARRANGEMENTS

Clients must understand the extent of their financial responsibilities to the CPA. The engagement letter should explain the fees in a way that makes them predictable.
depending on the services rendered and include a formula for computing fees that is easy for clients to understand. If these basic rules are followed, the client should not be charged an excessive amount based on the work performed. Keeping clients abreast of the amounts that will be due can greatly reduce problems with collecting fees. A "no surprises" approach to billing is an effective method for helping clients feel as if they are being treated fairly. Charges should be estimated upfront with assurances that any changes will be disclosed when discovered and that the client will have an opportunity to discuss or negotiate any changes. Fees for additional services are much easier to collect when clients are not surprised with an unexpected invoice at the end of the job.

Common methods for billing include some combination of a fixed fee, hourly charges, a retainer, or a charge for each type of tax form completed. It is important for the fee arrangement to also address reimbursement for the CPA's out-of-pocket expenses, if appropriate. The fee section of the engagement letter might also address the timing of billing, expected payment dates, and any methods for resolving disputes.

**ACCEPTANCE BY THE CLIENT**

A properly drafted engagement letter should require that the client sign and return the letter to confirm that he or she has read, understood, and agreed with its terms. Because it is a contract, the engagement letter should be signed before the CPA begins the work. If the signed engagement letter is not received before the work commences, a certified letter, with a return receipt, might be sent to the client requesting immediate return of the signed engagement letter. This certified letter might indicate that if the engagement letter is not signed and returned, the CPA will assume that the client agrees with its terms, but a signed engagement letter is always better. The size and complexity of the tax services engagement, as well as the fees involved, should dictate the degree to which the CPA will seek positive confirmation of the engagement terms.

**SUMMARY**

Best practices in the performance of tax services support the use of engagement letters in all engagements. If properly prepared, the engagement letter allows the CPA and the client to have a good understanding of all facets of the engagement. Furthermore, it mitigates any potential confusion over the services rendered, prevents unnecessary professional liability lawsuits, and promotes timely collection of fees.

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