FINRA Award Goes to Client After Advisor's Tax Oversight

Subpar tax advice from advisors can lead to big rewards for clients — but not the kind of rewards you want them to reap.

In a recent FINRA case, an elderly woman and her daughter were awarded more than $50,000 for what an arbitrator deemed insufficient advice regarding the tax consequences of an IRA distribution.

The payment was awarded even though the claimants had only suffered an increase in taxes of about $9,000 as a result of the total distribution of a roughly $30,000 IRA CD, and despite the fact that no investment had been purchased from the advisor in question.

How did this happen?

Marilyn Green, the elderly woman in question, owned a CD in an IRA that was held with Bank Atlantic. As Marilyn was already in her 80s and suffering from dementia and depression, her financial affairs were largely tended to by her daughter, Melissa Green, who had been granted power of attorney.

Sometime close to the CD's maturity date, Melissa Green discussed her mother's CD with Samuel Izaguirre, a Fort Lauderdale-based registered representative of LPL Financial. LPL and Izaguirre had entered into an agreement with Bank Atlantic to provide investment advice and brokerage services to its clientele.

THE RECOMMENDATION

During Melissa's conversation with Izaguirre, he recommended that Melissa withdraw the approximately $30,000 held in the maturing IRA CD and place the funds in a personal checking account. He did not provide any information with respect to the potential tax consequences of such a transaction.

Following Izaguirre's advice, in August of 2014 Melissa closed the IRA CD and transferred the funds to her mother's personal checking account.

The following year, when Melissa visited her mother's tax preparer to complete her 2014 return, she learned that the $30,000 IRA distribution resulted in roughly $9,000 of additional income taxes. Melissa was not happy, and the Greens filed a complaint that ultimately made its way to a FINRA arbitrator.

The FINRA case also alleged a number of causes of action, such as negligence, gross negligence, breach of duty of good faith, and fair dealing and negligent misrepresentation/omission. Obviously, none of these are terms any advisor or firm wants associated with their name.

The Greens sought a veritable laundry list of awards and remuneration, including:

- Compensatory damages of $9,000.
- All costs and expenses associated with the FINRA arbitration.
- All attorneys' fees incurred in connection with the arbitration proceeding.
- Punitive damages of at least three times compensatory damages.
- Additional amounts to cover the tax bill resulting from any award.

For their part, LPL and Izaguirre vehemently objected to the Greens' claims. Amongst other requests, they asked the arbitrator to deny the Greens' claims in their entirety, expunge the incident from Izaguirre's record and to award reasonable attorneys' fees, arbitration costs and other expenses.

The Arbitrator's Decision

According to the arbitrator, Barth Satuloff, the Greens showed an actual and implicit business relationship with Izaguirre and showed that he held a "position of trust."

The arbitrator further concluded that Izaguirre breached the relationship of trust by failing to provide information about the possible tax consequences of his recommendation.

Amazingly, the Greens were awarded a grand total of more than $50,000.

The award included $10,260 in compensatory damages, $20,202 in attorneys' fees and $21,240 in treble damages pursuant to a Florida state law preventing the "exploitation of an elderly person,"

additional words that no advisor wants to see anywhere near their name.

Izaguirre was not accused of recommending an investment gone awry. He was not accused of providing the Greens with incorrect tax information or advice. Instead, Izaguirre was accused of “failing to notify claimants regarding the adverse consequences” of his recommended transaction.

So the question becomes, did Izaguirre really have a responsibility to address the tax consequences of his recommendation with clients? This arbitrator certainly thought so.

SLIPPERY SLOPE

The arbitrator’s decision in this case could create a slippery slope. Although the decision says that the explanation is “for the parties only and is not precedential in nature,” that may not be the case in reality.

You can be sure that securities attorneys made note of this decision and are adding “s/he didn’t provide appropriate tax information” to their arsenal of potential “gotchas.”

Furthermore, given the success of the Greens in this case, other clients in similar predicaments may be emboldened and more willing to pursue claims against their advisors. Thus, if a FINRA-regulated professional’s failure to provide sufficient tax information can result in such an award, it’s certainly reasonable to think that a financial professional who is legally held to an even higher standard of care could find themselves in a similar position, if not worse.

Also worth keeping in mind is that, while the Greens themselves claimed that Izaguirre’s failure to provide them with adequate tax information led to a $9,000 tax bill, their ultimate award was for more than $50,000. That’s more than the entire IRA CD in question was worth. That raises the question, what if the investment in the CD hadn’t been $30,000 but instead was $300,000? Instead of a $52,000 award, it could have been a $520,000 award.

And what if the mistake had involved a million-dollar IRA? The bigger the account, the larger the potential consequences of making a mistake.

And of course, the actual award is only a small part of the problem here. As evidenced by the Green case, even a mistake with a fairly modest IRA could cause long-lasting, or even irrevocable, damage to an advisor’s professional reputation.

POSSIBLE SCENARIOS

One also has to wonder in what other situations failure to provide adequate information regarding adverse tax consequences could be applied.

For instance, all of the following scenarios could possibly result in adverse tax consequences:

- Selling a non-qualified asset and triggering a resulting capital gain.
- Taking a distribution from a non-qualified annuity that results in ordinary income.
- Suggesting a client make salary deferrals to a Roth 401(k) instead of a tax-reducing traditional 401(k) or suggesting an in-plan Roth conversion, both of which are irrevocable elections.
- Failing to suggest a qualified charitable distribution to a 70½+ year-old client who is charitably inclined and making “regular” charitable contributions.
- Not informing a client about the “new” once-per-year rollover rule.

Could we soon see advisors facing FINRA arbitration or other actions for any of the above? Perhaps. After all, once Pandora’s Box has been opened there’s no telling where it will lead.

Note that Roth IRA conversions can also create negative tax consequences (although they are often beneficial over the long run). They are not included in the above list, however, because they can generally be undone – recharacterized – even after such tax consequences are discovered by a client’s tax professional.

For instance, if an advisor errantly recommended a Roth IRA conversion in 2015 or failed to adequately explain the “adverse tax consequences” to a client, the resulting tax bill would generally be ascertainable now, as the client completed their 2015 tax return.

In the event the client was unhappy with the tax consequences of the transaction, there would still be ample time to correct the issue via a recharacterization.

While it’s possible a client could raise the issue after the recharacterization deadline had passed, they’d presumably be in a much weaker position after having seen their tax advisor and not raising the issue at that time. The Greens, on the other hand, raised the issue right away.

BEST WAYS TO PROTECT YOURSELF

In the past, advisors of all sorts have attempted to shield themselves from various liabilities by providing generic disclosures, such as “ABC Financial and its Representatives/Advisors do not provide tax or legal advice. For tax and legal advice, please consult with a qualified professional.”

The outcome in the Green case shows that such disclosures may play only a very limited role in helping to shield an advisor from potential issues. There’s probably no single action that advisors can take to completely insulate themselves from potential lawsuits, arbitration or other claims arising from the tax and/or legal matters that are generally outside their primary area of practice. However, there are certainly some steps that can be taken to reduce the chances of such actions becoming reality.

First and foremost, advisors must be armed with up-to-date tax and legal information, and they must be proactive in providing that information to clients. As the Green case illustrates, being passive and passing the proverbial tax and/or legal buck down the road may not be good enough. While actual tax and/or legal advice should generally still be left to the professionals who practice in those areas, providing information may be the future standard of care to which advisors are held.

For example, an advisor might help shield themselves from liability by saying to a client, “I think we should sell XYZ stock because I believe it’s going to go down in value, but if we do, you may incur a capital gains tax.” Perhaps that single statement, if well-documented, could be enough to protect an advisor.

Another strategy advisors might consider employing is to work more closely with a client’s tax and legal advisors. If strong lines of communication are established, an advisor can simply run a proposed transaction by such advisors to get their blessing or, at the very least, a tacit endorsement that whatever the advisor is proposing won’t have substantially negative consequences.

In truth, this is probably the best line of defense for financial advisors who don’t also serve as their client’s tax or legal advisor. Establishing a team approach may allow advisors to nurture contacts with other professionals, who could become valuable referral sources.

This case reinforces a powerful message for advisors: There has never been a time where advisor education and knowledge has been at a higher premium.

Ed Slott, a CPA in Rockville Centre, N.Y., is a Financial Planning contributing writer and an IRA distribution expert, professional speaker and author of several books on IRAs. Follow him on Twitter at @theslottreport.

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