Back to basics

Tax and professional negligence

SPEED READ **Professional negligence actions disputes can provide significant challenges because the relevant general law tests in contract and tort must be applied against the background of tax and commercial considerations which are rarely straightforward. Individual cases can turn on a wide range of legal points or detailed matters of fact. The hurdles facing potential claimants should not be underestimated. However, advisers will want to protect themselves appropriately. Two lessons from recent case law are that care should be taken to review the scope of retainers periodically and that advisers are better protected when they actively point out areas which may require further consideration and tell the client to take appropriate advice.**

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It is a sobering thought that those of us who give tax advice are potentially one slip away from being held liable for negligence. Tax advisers are at high risk from such claims for four reasons. First, the UK tax code is very long and extremely complex; it is all too easy to overlook a relevant provision or case.

Secondly, tax statutes are 'black letter law' which, once properly understood and applied, generally produce clear results. With hindsight errors can appear all too obvious.

Thirdly, it is difficult to argue that a reasonable tax practitioner cannot correctly ascertain the tax charge, or at least identify and sensibly apply the relevant provisions, against any set of facts. In contrast, a doctor cannot control how his patient responds to treatment and the outcome of litigation, including tax litigation, depends upon what the other side does as well as any judicial ruling.

Finally, the UK tax code is often disproportionately complex to the amount at stake and this inevitably creates tension between clients' reasonable budgets and the effort required of advisers.

The purpose of this article is to discuss the hurdles which need to be overcome for a claim to succeed and to illustrate some areas where there may typically be scope for argument. It must be emphasised that all of the relevant tests should be considered against the facts of any individual case. Whilst focus naturally gravitates towards finding errors within the scope of an adviser's retainer, it is important not to overlook the other hurdles which need to be overcome. Just because an adviser makes a mistake does not mean that there is a good claim against him.

The duties owed to clients

An adviser owes concurrent duties to her client in contract and tort. The contractual documentation governing the adviser's terms of engagement is central to defining the scope of those duties. It is of course essential that the engagement letter states precisely what tax advice is being given. An adviser is expected to exercise reasonable care and skill of the standards to be expected of her profession. The test looks to the part of her profession to which the adviser belongs rather than to seniority. Specialists will be held to a higher standard but there is no concession for inexperience. If an organisation has specialist skills then it would be expected to deploy them. This is potentially problematic where, for example, a law firm's tax department is not instructed or a firm of accountants does not deal with certain taxes, such as VAT and SDLT, in a particular transaction. The solution is to make clear what areas responsibility is being taken for and, wherever possible, point out other areas which need addressing.

The courts have tended to impose high standards. In *Hurlingham Estates Ltd v Wilde & Partners* [1997] STC 240, a solicitor in general practice who failed to advise his client as to the potential application of the lease premium income tax rules was held negligent despite not holding himself out as having specialist tax expertise. It is apparent that Lightman J felt that the defendant solicitor should have at least ensured that the client was told to take tax advice from someone with appropriate expertise. In contrast, the defendant accountants ultimately prevailed in *Mehjoo v Harben-Barker* [2014] STC 1470 because they alerted the claimant to the possibility that there might be more radical tax schemes available to him on the basis that he might be non-domiciled and so had discharged their duty as general accountants rather than tax specialists. These cases illustrate the importance of identifying the potential tax issues and telling the client that he should consider them. It is also relevant that the planning in *Mehjoo* was optional whereas in *Hurlingham Estates* the charge arose from the transaction undertaken.

Third parties

A potentially difficult question is whether the adviser owes any duty of care to third parties with whom he does not directly contract. A third party cannot rely on a contract unless that contract either provides that he can or confers a benefit on him and it does not appear that the parties to the contract did not intend him to be able to enforce it. In tort, there is no one set test as to whether a duty of care is owed: see *C & E Commrs v Barclays Bank* [2007] 1 AC 181. However, the courts will look at the purpose for which the advice is given and who might reasonably be expected to rely on it: see *Henderson v Merrett Syndicate Ltd* [1995] 2 AC 145, where the House of Lords held that

Lloyds managing agents owed duties in tort to both indirect and direct names. If a transaction is intended to benefit a specified beneficiary then that person will also be owed a duty: see *White v Jones* [1995] 2 AC 207. In contrast, if the adviser makes clear in her engagement letter both that she is not advising a particular person and that that person will need to take his own tax advice then no duty will be owed: see *Pegasus Management Holdings v Ernst & Young* [2010] EWCA Civ 181. An argument which may be worth making where a tax scheme is in point is that the law should not impose a duty in tort in respect of arrangements designed to avoid the State's own taxes, but to the author's knowledge no such argument has yet been advanced in court.

Proving a breach of duty

A claimant must also prove breach of duty. The precise scope of an adviser's duty is closely linked to the question of breach. Missing an obvious statutory provision would generally be a breach of duty. As in any dispute, facts are crucial and need to be proved with evidence. *Mehjoo* ultimately turned largely on a checklist of 12 bullet points which was produced for a meeting. In contrast, the defendants in *Hurlingham Estates* had no written evidence to support their contention that they told the claimant they were not advising on tax and advice would need to be obtained from elsewhere. Needless to say, wherever possible advisers should retain records of both advice and the limitations on their engagements. Normally expert evidence will be required in respect of the alleged breach, although traditionally this has been unnecessary when considering the duties of solicitors in general practice.

If a transaction has not been correctly implemented then this may also give rise to a breach. Given that HMRC is increasingly keen to attack the factual basis of transactions and especially any tax saving arrangements then this is an area of increasing concern. A key issue in practice is to determine who is responsible for implementation. This is potentially problematic when a client takes advice from tax in relation from his accountants and then asks his solicitors to implement that advice. It is much better to ascertain responsibility at the time the transaction is entered into; the short point is that someone with tax expertise should supervise implementation.

The *Bolan* test

Just because a client pays tax where he was advised that none should be payable does not mean that someone has been negligent. Where an adviser has considered the relevant provisions and taken a reasonable view as to how these apply then following the *Bolan* test (*Bolam v Friern Hospital Management Committee* [1957] 1 WLR 582) – which says that a professional is not negligent if he acts in accordance with responsible practice – he will not be negligent if the courts ultimately find that view to be incorrect. This is a significant obstacle for any disappointed client who has purchased a tax scheme. On the other hand, there may be those who seek to argue that a view did not accord with responsible practice and it is not difficult to envisage battles of expert evidence on this point. It should also be noted that there is authority that professionals should alert their clients to obvious risks: see eg per Bingham LJ in *County Personnel (Employment Agency) v Pulver* [1987] 1 WLR 916, although the claimant will still need to prove loss.

Three other points are worth noting in relation to breach of duty which space precludes from detailed consideration here. First, an adviser who properly instructs and follows the advice of specialist tax counsel will generally have discharged his duty, although an adviser cannot simply abdicate responsibility: see further *Matrix Securities Ltd v Theodore Goddard* [1998] PNLR 290. Secondly, a finding that an adviser is negligent or careless for the purposes of TMA 1970 does not automatically mean that there is a breach of duty; although clearly it is not going to help the adviser: see *Smith v HMRC* [2011] STC 1274. Finally, an important question which merits judicial consideration is the extent to which the reasonable adviser's standard of advice can be reduced owing to time pressure. A closely related concern arises in transactions with disproportionately complex tax consequences; the SDLT partnerships regime in the rural sector is a potential example of this.

The difficulties for potential claimants should not be underestimated

Loss must be suffered

The claimant must also suffer relevant loss. Essentially, damages seek to put the claimant in the same position as if the duty had been performed. A hugely important question is to ask what would have happened absent the breach. If the answer is that the transaction would have taken place anyway in exactly the same way then the claimant's only loss should be any interest and any penalties plus perhaps any fees. The recovery of fees is not automatic, as is sometimes asserted. The result may very well be the same where an aggressive scheme designed, for example, to reduce the taxpayer's liability to income tax fails.

To recover the tax in this situation then the burden is on the claimant to prove that he would have done something else which would have been effective to save the tax: see further *Grimm v Newman* [2002] STC 1388. By way of a further example, the author once had to consider a situation where an EIS scheme had been improperly established because the shares were

not issued fully paid up. In order to succeed, the claimants needed to show that they would have been able to fund the issue of the shares using significant amounts of cash and this presented them with a major obstacle.

Damages are assessed on the balance of probabilities by reference to what the claimants would have done absent the breach. All sorts of hypothetical arguments may be made depending on the facts of the individual case.

The loss must also be reasonably foreseeable as a natural consequence of the breach.

Limitation periods

As regards limitation, the general rule is that claims are time barred from six years after the cause of action accrues. In contract, this is the date of the breach and will be when the advice is given. In tort it is when the damage occurs and this will normally be either when the tax charge arises or when interest starts to run. In addition, there is an alternative time limit which applies in tort only which is three years from the claimant obtaining knowledge of the damage: see Limitation Act 1980 s 14A. All claims are subject to a 15-year time limit from the date of the negligent act: see Limitation Act 1980 s 14B. It is important not to overlook limitation, the author has seen more than one potential claim fail for being out of time.

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Contributory negligence

A defendant's liability may be reduced for contributory negligence by the claimant. Damages can be reduced on a just and reasonable basis to take account of the claimant's responsibility for any loss under the Law Reform (Contributory Negligence) Act 1945 s 1. In the author's view there may be greater scope for running this argument in relation to tax related claims than is generally imagined, especially where the claimant is in business. One example where a client may be potentially culpable is in failing to assist in co-ordinating in the implementation by refusing to incur costs in paying for supervision of the documentation by the tax advisers. The question of time pressure is also potentially relevant here: it may be argued that a client is contributorily negligent by delaying taking tax advice until the last minute so that the adviser was not given a reasonable opportunity to perform his duty. There is a technical issue as to whether contributory negligence can be pleaded against contractual claims but the better view is that it can where the duty is identical to that owed in tort: see *Forsikringsatktieselkapet Vesta v Butcher* [1986] 2 All ER 488. Defendants may also claim contribution from others responsible for the loss.

Exclusion clauses

Advisers may seek to protect themselves using contractual exclusion clauses. A well-drafted exclusion clause should be effective. The exclusion must be reasonable otherwise the clause can be held ineffective under the Unfair Contract Terms Act 1977 s 2(2). A clause which imposes a financial cap on a defendant's liability is likely to be reasonable provided that the cap is significant, for example where this reflects an appropriate level of insurance: see, for example, *Marplace (Number 512) Ltd v Chaffe Street (a firm)* [2006] EWHC 1919 (CH). A restriction of liability is also more likely to be reasonable where the contracting parties are both businesses. Where an individual deals as a consumer then unfair terms can also be struck out under the Unfair Terms in Consumer Contracts Regulations, SI 1999/3159. Advisers will also need to consider whether regulatory requirements permit the use of exclusion clauses. For example, when dealing with natural persons not acting for business purposes then solicitors are unable to exclude liability for negligence in a contentious business agreement by virtue of the Legal Services Act 2007, although this should not cover tax advice.

Action points for advisers

Obtaining suitable insurance, carefully reviewing the terms of engagement and instructing counsel are obvious steps to guard against professional negligence actions.

One of the lessons of *Mehjoo* is that advisers should beware 'mission creep' and regularly review the scope of their responsibilities. It is to be emphasised that the courts react much better where, rather than simply disclaiming responsibility for certain tax issues, the adviser makes an effort to identify those issues, at least in outline, and tells the client to take further advice. The burden is then on the client to take action.

Care must also be taken to avoid implementation errors and this will generally require someone with suitable tax expertise reviewing any documentation. Where risks are identified, as almost inevitably they will be in most transactions, then these should be flagged clearly and in writing to the client.

When considering a claim in professional negligence, from whichever perspective, the key is to consider all of the relevant hurdles which the claimant needs to jump in order to succeed. Advisers will need to be familiar with both the tax and commercial background in order to consider especially matters relating to the scope and breach of duty as well as causation and loss. The difficulties for potential claimants should not be underestimated and it is noteworthy that Mr Mehjoo ultimately finished up being liable for significant costs. ■

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