Bring in an expert

SIMON MCKIE considers the role of the specialist witness when tax advice goes wrong.

Getty.com

Tax is complex and the financial consequences of a mistake can be catastrophic. Deciding where the legal liability for the consequences of such a mistake lies itself calls for high levels of professional knowledge and judgment, and those who specialise in litigation cannot be experts in revenue law and practice. The court, in reaching its decisions in such cases, must form a judgment on many matters requiring professional experience in the practice of taxation. In cases concerning negligent tax advice, the litigator and the court require the aid of an expert.

The courts have heard expert evidence at least since the sixteenth century (see *Buckley v Rice Thomas* (1554) 1 Plowd 118). An expert witness falls into a special category governed by Part 35 of the Civil Procedure Rules (CPR) and the Practice Direction 'Experts and Assessors'. Guidance on their application is given by the *Civil Justice Protocol for the Instruction of Experts to give Evidence in Civil Claims*. An expert witness will owe a contractual duty to the party engaging his services under normal contractual principles, but his overriding duty is to help the court in matters within his expertise. Under CPR, Part 35.1, 'expert evidence should be restricted to that which is reasonably required to resolve the proceedings'. Without the court's permission an expert cannot be called to give evidence and an expert report cannot be put in evidence (see CPR 35.4(1)). Even if the evidence is admitted, *R v Rivett* (1950) 34 Cr App Rep 87 determined that the weight attached to it is a matter for the court.

However, in *Sansom v Metcalfe Hambleton & Co* [1998] 26 EG 154, it was held that a court should be 'slow to find a professionally qualified man guilty of a breach of his duty of skill and care towards a client … without evidence from those who are in the same profession as to the standards expected on the facts of the case and the failure of the professionally qualified man to measure up to that standard'.

KEY POINTS

- The history of the expert witness.
- The extent of the duty of care when advising.
- Quantifying the loss caused by negligent advice.
- Ensure that all relevant factors are considered.
- Could a loss have been mitigated?
- The importance of mediation in negligence proceedings.

Determining the law

It is the court's task to determine the effect of the law of England and Wales in respect of the facts relevant to the case. Paradoxically, therefore, where a tax adviser acts as an expert witness, one matter on which he cannot give evidence is on his primary area of expertise: the content of the revenue law and of its application to the facts. In giving evidence, however, on such matters as what advice a reasonably competent tax adviser would have given had he been in the same circumstances as the adviser alleged to have been negligent, it is inevitable that his evidence will refer to the expert's understanding of the legal effect of the provisions relevant to the allegedly negligent advice.

Long before the matter comes to court, the litigating solicitor will require the support of a taxation expert to fully understand all the elements of his client's case. A taxation expert will not only provide to the litigator his opinion on matters on which he might give evidence were the case to proceed to a hearing, but also on the application of the revenue law relevant to the allegedly negligent advice. His advice will be of importance in relation to all of the elements of the case; that is, as to duty, breach, causation and quantum.

In the ***Example***, a client alleges professional negligence in respect of tax advice on enterprise investment scheme (EIS) deferral relief.

Duty

In the ***Example***, did the accountants, BJS, have a duty to give correct advice in respect of the consequences of the proposed transaction for the EIS relief which he had claimed? The exact terms of Mr Glucose's request for advice on the property transaction is a matter of evidence which BJS and their solicitors need to determine, but once the factual background is determined, unless it is entirely straightforward, the expert will give his opinion of whether a reasonably competent tax adviser would have understood that request to be a request for advice not only in relation to the company's tax affairs, but also in relation to Mr Glucose's personal affairs.

Breach of duty

If BJS did have a duty to advise on the EIS consequences of the property transaction should BJS have warned Mr Glucose that if the transaction were at an undervalue it would lead to a clawback of the EIS reliefs? An adviser receiving the closure notice might well argue that a purposive interpretation of the relevant legislation would restrict the extent of the deeming provision of TCGA 1992, Sch 5B para 13(10). However, a reasonably competent tax adviser, called upon to give advice in relation to EIS deferral relief, would surely have advised that on a literal reading such a transaction at an undervalue would be a return of value, that there was a good chance both that HMRC would raise an assessment on the basis that there was a chargeable event under TCGA 1992, Sch 5B para 3(1)(c) and that a court would confirm the assessment.

Causation

BJS's litigating solicitor will want to examine closely the question of reliance on the advice. If Mr Glucose would have proceeded with the transaction even if he had been properly advised then he would not have suffered loss as a result of BJS's breach. Mr Glucose had been advised that if GPL sold the property for less than its market value a tax charge would arise, but he proceeded with the transaction in any event. Perhaps he did so thinking that the transaction price was at market value? What evidence is there that, if Mr Brown had advised him of the possibility of the withdrawal of EIS relief, he would have altered the proposed transaction? Important though that question is, it is not one to which the expert's evidence is likely to be very significant. No doubt, he could give evidence of his experience of how other clients have typically approached similar decisions, but the probative value of such evidence in relation to Mr Glucose's reliance or otherwise on Mr Brown's advice would be very small.

The income tax liability

Quantifying the damage suffered if the advice was negligent and Mr Glucose relied on it is rather more complicated than it looks. One might think that one could not take account of the income tax liability because Mr Brown specifically warned Mr Glucose that it would arise if the transaction took place at an under value. The measure of the damage resulting from BJS's failure to point out the EIS consequences of the proposed transaction, however, is the difference between Mr Glucose's actual position and the position he would have been in, had the advice been given. If it is the case that he would not have proceeded with the property transaction had he been warned about its EIS consequences, he would not have incurred either the capital gains tax or the income tax liability and therefore the liability for income tax is part of the measure of his damage.

A deferral, not an absolute liability

BJS might argue (see TCGA 1992 Sch 5B para 3(1)) that relief under s 150C only defers liability until a later disposal of the shares. Mr Glucose's response to that would be that he might have retained the shares until his death so that no gain would arise. On this issue, the expert could give evidence from his experience of what proportion of clients claiming EIS relief do actually crystallise at a later stage the gain which they have held over.

Carbon's remuneration

The really interesting issues as to quantum, however, arise in respect of the prior transaction with Carbon.

Any transaction with Carbon which would be a return of value if made with Mr Glucose will be a return of value in accordance with TCGA 1992, Sch 5B para (10)(b) and para 19. The payment by a company of remuneration for services as an employee which is not such remuneration as may be reasonable in relation to the duties of that employment is a return of value (see TCGA 1992 Sch 5B Para 13(2)(i) and (7)(a)). It is a question of fact whether

> ***"Quantifying the damage suffered if the advice was negligent is rather more complicated than it looks."***

the payment made to Carbon was reasonable in relation to his duties and that is not a question on which a person expert as a tax adviser could give expert evidence. Nonetheless, it is an issue which BJS's litigating solicitors should investigate. Assuming that the remuneration was not reasonable in relation to Carbon's duties there would have been a return of value, as a result the shares would have ceased to be eligible shares and there would have been a chargeable event under which all of the gains held over by Mr Glucose would have been brought into charge.

The result of that is that although the property transaction was a chargeable event, no gains would have accrued to Mr Glucose by reason of it. So arguably the capital gains tax charge should not form part of the quantum of his claim.

Also, rather strangely, in this case BJS would be in a better position if Mr Brown had been aware of the transaction with Carbon at the time he advised Mr Glucose than if he had not. In that case, his proper advice to Mr Glucose (subject to para 13B which we discuss below) would have been that although the property transaction was a chargeable event it would not lead to a capital gains tax charge because that charge had already accrued. As we have seen, Mr Glucose was willing to proceed

EXAMPLE 1

Mr Glucose is a director and owns the entire share capital of two companies, Industrial Cider Limited (ICL), which manufactures industrial cider, and Glucose Properties Limited (GPL) which owns various let residential properties.

Mr Glucose has engaged Brown, Jones & Smith LLP, Chartered Accountants (BJS), to prepare the companies' accounts and to audit them, to act as his own and the companies' tax agents and to 'provide taxation advice on request from time to time' in respect of his own and the companies' affairs. Accounts are made up to 30 April in each year.

On 1 January 2009, Mr Glucose invests £900,000 in ICL and claims enterprise investment scheme capital gains tax deferral relief on his investment under TCGA 1992, s 150C. From 1 August 2009, ICL employed Mr Glucose's son, Carbon, for one month during his first vacation from university as a marketing consultant paying him £5,700, an amount which was chosen as being just below the earnings threshold. On 1 December 2009, Mr Glucose telephoned Mr Brown of BJS for advice in respect of a proposal that GPL should sell ('the property transaction') a building (the 'property') to Mr Glucose for £1 million. He asked to be advised whether the property transaction would have to be disclosed in GPL's accounts and if there would be any adverse tax consequences in respect of it. He was advised that the transaction should be disclosed and that, if the selling price was less than the market value of the property, there would be a benefit in kind charge under ITEPA 2003, s 206.

On the 30 January 2012, HMRC opened an enquiry into Mr Glucose's return for 2009/10 and in the course of that enquiry the Valuation Office arrived at a final value for the property at the date of the property transaction of £1,200,000. The inspector issued a closure notice assessing a benefit in kind of £200,000 and a capital gain of £900,000 accruing under TCGA 1992, Sch 5B para 4 on the basis that the sale of the property by GPL to Mr Glucose at an undervalue was a return of value within Sch 5B para 13(2)(g), treated as having been made by ICL by reason of Sch 5 para 13(10). He therefore increased Mr Glucose's income tax assessment by £80,000 ((£1,200,000 – £1,000,000) @ 40%), and raised a capital gains tax assessment of £162,000 (£900,000 @ 18%). The inspector also raised a penalty for the careless error in the tax return of £72,600 ((£162,000 + £80,000) @ 30%).

Mr Brown of BJS, having considered the inspector's letter, rang Mr Glucose, explained the assessment to him and admitted that he had overlooked that, if it took place at an undervalue, in addition to being a benefit in kind the property transaction would also be treated as a return of value by ICL leading to a clawback of all of the EIS deferral relief claimed within the previous three years. He advised Mr Glucose that he might be able to avoid the capital gains tax charge by replacing an amount equal to the undervalue of £200,000 in the company.

Mr Glucose's solicitors subsequently issued proceedings for breach of contract and negligence claiming damages on the basis that BJS were engaged to provide taxation advice on the consequences of the property transaction, their advice was negligent, that Mr Glucose had relied on that advice in taking the decision to proceed with the property transaction, that he would not have proceeded had correct advice been given and that he had suffered damage of £314,600 (£162,000 + £80,000 + £72,600) plus interest as a consequence.

with the transaction even though he had been warned about the income tax charge so he would not have then been in any better position had he been properly advised because he would, presumably, have proceeded with the property transaction in any event. If, however, Mr Brown was not aware of the transaction with Carbon at the time he advised on the property transaction, a reasonably competent adviser would have advised Mr Glucose of the risk that the property transaction would trigger a clawback of the EIS relief with the result that, if Mr Glucose, on the basis of that advice, would not have proceeded with the transaction, the income tax charge would be damage which he would have suffered from relying on the incorrect advice of Mr Brown.

Replacement of value

Paragraph 13B provides that where there has been a return of value, the return of value is reduced to the extent that the value is replaced in the company concerned. Under para 13C(2)(b) it must, however, be replaced as soon after the original return of value 'as is reasonably practical in all the circumstances'. The existence of this provision has two effects on Mr Glucose's claim.

It appears that Mr Brown advised Mr Glucose about this provision. A claimant for damages for breach of contract has a duty to mitigate his loss. It is arguable that Mr Glucose should have mitigated his loss by replacing value in the company. Did he fail to do so? Was he advised that the time was already past at which it was first reasonably practical for him to have replaced the value so that relief under paras 13B would not apply? Did he do so, but fail to persuade HMRC that the relief applied? In that case, should he have appealed against the closure notice? These are issues for further enquiry which an expert would highlight for the litigating solicitors and, once further evidence was gathered, on which an expert might give evidence as to the approach which would have been adopted by a reasonably competent tax adviser.

Section 13B and s 13C also affect BJS's argument in relation to the transaction with Carbon. For if Mr Brown became aware of that transaction within the time that it was still possible to replace value in the company satisfying the condition that that was as soon as possible as was reasonably practical in the circumstances, then a reasonably competent adviser would have advised Mr Glucose to do so at the time Mr Brown gave his advice in respect of the property transaction. In that case, the prior transaction with Carbon would not have prevented the clawback of Mr Glucose's rolled-over gains being triggered by the property transaction.

The need for negotiation

The example shows that even in situations which appear quite straightforward, the issues raised in professional negligence litigation can be complex. The outcome of such cases is never entirely predictable. On the professional side, they will usually be managed by the professional indemnity insurers of the firm concerned who will usually be experienced and hard-nosed negotiators. It is rare for a client suing for professional negligence to achieve a result which he regards as fair compensation for his loss.

For the professional who is the subject of a claim, preparation for a court hearing is tremendously time consuming. His insurers will insist on his taking every effort to provide them with the information which they require and to prepare thoroughly for the hearing. Both sides, therefore, have a strong interest in negotiating a settlement so as to bring the issue to a close and to reduce their risk of the costs in the case.

Mediation

The Civil Procedure Rules provide that the overriding objective of the civil procedure code is to enable the court to deal with cases justly and, in furthering this objective, the courts must actively manage cases. Part of that active management is encouraging the parties to use an alternative dispute resolution procedure if the court considers that appropriate. In *Dunnett v Railtrack Plc (in railway administration)* [2002] EWCA Civ 303, *Burchell v Bullard* [2005] EWCA Civ 358, it was held that if one party refuses to do so he will be at risk of an adverse consequence in respect of costs. Rather, to my surprise, I have found mediation is a very effective way of concentrating the parties' minds on the relative strength of their positions and encouraging realistic negotiations.

Conclusion

Whether you are the claimant or the defendant, being a party to an action for negligence is extremely stressful and almost always deeply unsatisfying. A good expert can help reduce the stress and aid the achievement of a realistic outcome. For the expert there are few things more satisfying than bringing clarity regarding the application of revenue law to the often complex and messy facts of such a case.

Simon McKie is a designated member of McKie & Co (Advisory Services) LLP, the consultancy specialising in providing taxation advice to advisers of private clients (phone: 01373 830956 or e-mail: simon@mckieandco.com).