McKie&Co

SIMON McKIE

Expert Witnesses and Taxation[1]

LT Accountants; Deferral relief; Duty of care; Expert witnesses; Financial advice; Measure of damages; Professional negligence; Tax

Simon Mc Kie examines the role of the tax expert in litigation concerning professional negligence.

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. Those who specialise in professional negligence litigation cannot also be experts in revenue law and practice. The court, in reaching its decision in such cases, must form a judgment on many matters requiring professional experience in the practice of taxation. In cases concerning negligent tax advice, both the litigator and the court require the aid of an expert.

The courts have heard expert evidence at least since the 16th century.[2] An expert witness falls into a special category governed by the Civil Procedure Rules 1998 Pt 35 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 the Civil Procedure Rules 1998 r.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.[3] Even if expert evidence is admitted, the weight to be attached to it is a matter for the court.[4]

[1] An abridged version of this article appeared in *Taxation* magazine on November 18, 2009.
[2] *Buckley v Rice Thomas* 75 E.R. 182; (1554) 1 Plow. 118.
[3] The Civil Procedure Rules 1998 r.35.4(1).
[4] *R. v Rivett (James Frank)* (1950) 34 Cr. App. R. 87.

It has been held, however, that a court should be:

> ''[S]low 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.''[5]

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 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 understand all the elements of his client's case. A taxation expert will therefore 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.

Finding an expert witness

There are various membership organisations for expert witnesses, some of which offer accreditation and training, including the Expert Witness Institute, the Academy of Experts and the Society of Expert Witnesses. Enquiries to the Law Society will be referred to ''Legal Hub'', a web-based service provided by Sweet & Maxwell.[6] It lists over 2,500 experts, all of whom are vetted and have provided references in respect of previous work as expert witnesses.

An example

In the box below we give an example of a case of a client of a chartered accountancy firm who alleges that his accountants have been negligent in their provision of tax advice on Enterprise Investment Scheme (EIS) deferral relief.

[5] *Sansom v Metcalfe Hambleton & Co* [1998] 26 E.G. 154; [1997] E.G. 185 (C.S.) CA.
[6] See *http://www.legalhub.co.uk* [Accessed January 5, 2010].

Example

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

Mr Glucose has engaged Brown, Jones & Smith LLP (BJS), chartered accountants, 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 April 30 in each year.

On January 1, 2009 Mr Glucose invests £900,000 in ICL and claims EIS CGT deferral relief on his investment under the Taxation of Chargeable Gains Act 1992 s.150C. From August 1, 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 December 1, 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 the Income Tax (Earnings and Pensions) Act 2003 s.206.

On the January 30, 2012 HMRC opened an enquiry into Mr Glucose's return for 2009/2010 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 the Taxation of Chargeable Gains Act 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 para.13(2)(g), treated as having been made by ICL by reason of para.13(10). He therefore increased Mr Glucose's income tax assessment by £80,000 ((£1,200,000 - £1,000,000) x 40 per cent), and raised a CGT assessment of £162,000 (£900,000 x 18 per cent). The Inspector also raised a penalty for the careless error in the tax return of £72,600 ((£162,000 + £80,000) x 30 per cent).

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 under value, 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 claw back 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 CGT 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, Mr Glucose had relied on that advice in taking the decision to proceed with the Property Transaction, he would not have proceeded had correct advice been given and he had suffered damage of £314,600 (£162,000 + £80,000 + £72,600) plus interest as a consequence.

Duty

Did BJS have a duty to give correct advice in respect of the consequences of the proposed transaction for the EIS deferral 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. Once the factual background is determined, however, unless it is entirely straightforward, the expert will give his opinion on 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 deferral 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 the Taxation of Chargeable Gains Act 1992 Sch.5B para.13(10). A reasonably competent tax adviser, however, called upon to give advice in relation to EIS deferral relief would surely have advised that: (i) on a literal reading, such a transaction at an under value would be a return of value; and (ii) there was a good chance both that HMRC would raise an assessment on the basis that there was a chargeable event under the Taxation of Chargeable Gains Act 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 deferral 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.

Quantum

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 CGT or the income tax liability and, therefore, the liability for income tax would be part of the measure of his damage.

A deferral, not an absolute liability

BJS might argue that relief under s.150C only defers liability until a later disposal of the shares.[7] 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.[8] 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.[9] It is a question of

[7] The Taxation of Chargeable Gains Act 1992 Sch.5B para.3(1).
[8] The Taxation of Chargeable Gains Act 1992 Sch.5B paras (10)(b) and 19.
[9] The Taxation of Chargeable Gains Act 1992 Sch.5B paras 13(2)(i) and (7)(a).

fact whether 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 CGT 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 CGT charge because that charge had already accrued. As we have seen, Mr Glucose was willing to proceed with the transaction even though he had been warned about the income tax charge. The position, therefore, would then have been that Mr Glucose would not have 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 deferral 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 para.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 had been gathered, on which an expert might give evidence as to the approach which would have been adopted by a reasonably competent tax adviser.

Paragraphs 13B and 13C also affect BJS's argument in relation to the transaction with Carbon. 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. Even if the adviser has not been negligent, a case will consume enormous amounts of his most valuable resource—his time—and may also give rise to publicity which he is unlikely to welcome. The outcome of such litigation can never be straightforward. In *Grimm v Newman*[10] the well known tax adviser, John Newman, had given advice which appeared to most taxation experts at the time to have been exemplary. Yet Mr Newman was found in the High Court to have given negligent advice and the Court of Appeal reversed the High Court's decision only by a majority of two to one.

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 bearing the costs of the case which can sometimes exceed the value of the original claim.

[10] *Grimm v Newman* [2002] EWCA Civ 1621; [2003] 1 All E.R. 67.

Mediation

The Civil Procedure Rules 1998 provide that the overriding objective of the civil procedure code is to enable the court to deal with cases justly[11] and, in furthering this objective, the courts must actively manage cases.[12] Part of that active management is encouraging the parties to use an alternative dispute resolution procedure if the court considers that appropriate[13] and it will almost always do so. If one party refuses to enter into the procedure he will be at risk of severe costs sanctions.[14] 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.

What an expert can contribute

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.

[11] The Civil Procedure Rules 1998 r.1.1(1).
[12] The Civil Procedure Rules 1998 r.1.4(1).
[13] The Civil Procedure Rules 1998 r.1.4(2)(e).
[14] *Dunnett v Railtrack Plc* [2002] EWCA Civ 303; [2002] 1 W.L.R. 2434; *Burchell v Bullard* [2005] EWCA Civ 358; [2005] C.P. Rep. 36.