Summer 2013

Update°

Accountants' Liability

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Welcome to the DWF Fishburns Liability update, focussing on key insurance developments within the accountancy sector.

In this edition:

Stay Informed°

Our knowledge of insurance liability enables us to supply you with detailed information on the latest developments within the sector you work in.

Our updates aim to highlight the key cases, along with important legal and industry news, to ensure you are well informed on key issues that are important to you and your clients.

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Do accountants owe a duty to advise on tax avoidance schemes?

Whilst HMRC is busy clamping down on tax avoidance schemes [as reported elsewhere in this update], the High Court was reported in some circles recently as apparently placing the onus on accountants to advise clients to enter into tax avoidance schemes if such schemes would be beneficial.

Background Facts

In Mehjoo v Harben Barker [2013] EWHC 1500 (QB) Mr Justice Silber heard a long and complex professional negligence claim against the defendant accountants. The Claimant (and the Defendants' ex-client), Mr Mehjoo, was an Iranian non-domicile. He built up an enormous clothing business in England that he sold in April 2005, as a result of which he was liable for capital gains tax ("CGT") of around £850,000 on his share of the business. The Claimant accordingly sought the Defendants' advice on minimising his CGT liability.

On the Defendants' advice the Claimant invested in a Capital Redemption Plan ("CRP") operated by a company called Montpellier, which was intended to create a capital loss so as to avoid the CGT for which the Claimant was otherwise liable. However, the CRP scheme failed and the Claimant had to pay tax, interest and a penalty to HMRC. He sought to recover this from the Defendants, together with the costs of investing in the CRP scheme.

The Claimant alleged that, had he been properly advised by the Defendants then he would have sought expert advice from an adviser who specialised in non-domiciles, who would have advised him to enter into a different tax avoidance scheme available only to non-domiciles using Bearer Warrant Planning ("BWP"), which he would have done and which would have succeeded.

Decision

Mr Justice Silber upheld almost every element of the claim. In particular, the Judge held that it was negligent of the Defendants, who were generalist accountants, not to note the Claimant's non-domicile status and advise him to take specialist advice on the impact of that status in seeking to avoid CGT. The Judge then found, as a matter of fact, that if the Defendants had not been negligent then the Claimant would have taken such specialist advice, which would have been to invest in the BWP, which the Claimant would have done immediately, and which would have been successful.

The Claimant was therefore entitled to recover the CGT that he had paid but would have avoided through the BWP. The Judge also awarded the costs of entering the CRP scheme on the basis that they were a foreseeable loss caused by the Defendants' negligent advice to enter into that scheme. The Claimant was entitled to interest in addition, albeit that was reduced because he had not mitigated his loss by purchasing appropriate certificates of tax deposit from HMRC that would have stopped interest running.

Comment

Upon close analysis, this decision probably does not create new law or extend the duties of accountants to advise their clients to invest in tax avoidance schemes. Instead, the Court found that the Defendants had been negligent in failing to take proper account of the Claimant's status as a non-domicile in advising him how best to mitigate his CGT liability and advising him to take specialist advice on that point. The central issue for liability was therefore an old one – that the professional must carefully take account of all relevant facts in advising their client, and recommend that they take further specialist advice if appropriate.

What was perhaps unusual in this case was the Judge's confidence in accepting the Claimant's hypothetical account of what would have happened had he been properly advised. This part of the judgement turns on the particular facts, but it is nevertheless worth bearing in mind the importance in this sort of claim of how a Claimant says that they would have acted had they not been advised negligently.

This decision reminds Insurers of the importance of considering carefully the information given by Insured accountants about their practice and checking that the advisers are suitably qualified for the work that they undertake (and do not advise beyond their expertise). It also reinforces the importance of fully investigating what the Claimant might have done had he been advised properly, and doing everything possible to challenge that account.

Accountants themselves are reminded of the importance of fully investigating a client's background and considering all material facts carefully in advising them. This case is a salutary reminder of the warnings of overstepping one's knowledge and expertise.

We understand that the accountants are appealing the decision

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Docs before claim? That's generally not playing the game

As encouraged by the Civil Procedure Rules, professional negligence claims against accountants (and against other professionals) are at first usually pursued under the Professional Negligence Pre-Action Protocol (www.justice.gov.uk/courts/procedure-rules/civil/protocol/prot_neg). During this process, claimants occasionally apply to the court for an order for pre-action disclosure of an accountant's documents.

The decision of Mr Justice Blair in Assetco Plc v Grant Thornton UK LLP (25 January 2013) demonstrates the court's approach to such an application during the pre-action protocol stage of an audit negligence claim.

Background Facts

Assetco contemplated a claim against its former auditors, Grant Thornton, in circumstances where Grant Thornton had provided unqualified audit reports for two accounting years but new auditors subsequently substantially restated those accounts, referring to errors in the accounts.

Assetco sent a Preliminary Notice under the Protocol, identifying the differences between the original and restated accounts, adding that there were serious reservations as to whether reasonable skill and care had been performed in the audits. After Grant Thornton's acknowledgement, the next step was for Assetco to provide a detailed Protocol Letter of Claim. No such letter was provided. Instead Assetco applied to the court for pre-action disclosure, seeking 'all documents' in various categories which were held by Grant Thornton. During subsequent correspondence, Assetco said that it would provide draft Particulars of Claim. However later Assetco said that it was unable to fully plead particulars of negligence without the pre-action disclosure.

Decision

In subsequently dismissing Assetco's application for pre-action disclosure, the Judge focussed on the requirements for pre-action disclosure under the Civil Procedure Rules (rule 31.9; which we do not set out here). In doing so he concluded that:

- whilst there was no need to plead particulars fully at this stage, the issues arising in a professional negligence claim needed to be properly identified;
- Assetco had its own documents in relation to the audits and should have been able to ascertain why the new auditors restated the accounts and why on the material available Grant Thornton acted allegedly negligently in respect of the figures in the accounts. Until that was done it could not be said (as required by rule 31.9) that the documents sought fell within the scope of standard disclosure;
- the Protocol provides that: there can be a Preliminary Notice; the defendant need only acknowledge that notice; the claimant must then write a detailed Letter of Claim; the defendant has three months from acknowledgement to investigate; and the parties should supply promptly at that stage and throughout whatever relevant information or documentation is reasonably requested. Further whilst it is intended to encourage early exchange of relevant information, the Protocol should not be used as a "fishing exhibition". The Judge commented that the case had gone straight from a Preliminary Notice to a full application for pre-action disclosure and that was not desirable (which is another requirement under rule 31.9);
- if disclosure were to be ordered based on the issues as they appeared in correspondence, the disclosure process would have to be gone through again if proceedings followed. That would not save costs (another requirement under rule 31.9) and in this regard it was not an answer for Assetco to say that the cost of pre-action disclosure would be met by them (as is usual if pre-action disclosure is ordered);
- it was also relevant that the requests for pre-action disclosure were wide, in that they sought "all documents" in various categories which included any electronic and/or hardcopy documents, drafts, emails, manuscript notes, spreadsheets and memoranda in Grant Thornton's control, wherever they might be located. The Judge considered that that was disproportionate at the pre-action stage.

Comment

As the Judge recognised from previous authority, certainly in the commercial context (which will include claims against accountants) a pre-action disclosure order, even if not exceptional, is unusual. A claimant will often have to show it has followed the Protocol and recognise that the requirements of rule 31.9 are looked at strictly by the Court.

Legal advice privilege and accountants

R (on the application of Prudential Plc and another) v Special Commissioner of Income Tax and another [2013] UKSC 1

Background

Prudential started life over three years ago as a judicial review to the High Court by Prudential Plc and Prudential (Gibraltar) Limited (together "Prudential") of notices with which they were served in exercise of HMRC's investigatory powers in order to investigate a commercially-marketed tax avoidance scheme. Prudential argued that the notices sought material that was covered by legal advice privilege ("LAP"), as it comprised communications between client and accountant for the purposes of obtaining skilled professional advice on tax law. HMRC did not accept this and countered that Prudential was asking the Court to extend the ambit of LAP to create a new right to protection from disclosure.

Decision

The Supreme Court rejected Prudential's arguments by a majority of five to two. Giving the lead judgment for the majority, Lord Neuberger refused to go against the long-standing and universally accepted limits of LAP and extend it beyond communications between clients and their lawyers. Lord Neuberger was concerned about the uncertainties that would follow from changing the scope of LAP, not least in knowing who could claim it, whether their professional work ordinarily included giving legal advice and how the Court should deal with written advice that was partly legal advice and partly other advice. He felt that the matter should be left to Parliament and not be resolved by the Courts.

The minority of the Supreme Court focused on the function of LAP and its character and context, rather than the identity of the professional giving it. In this way they did not consider that LAP would be extended to cover legal advice given by accountants; rather, the Court would simply be recognising that accountants gave skilled legal advice as part of their work, to which LAP naturally attached.

Comment

Whilst the lower courts had some sympathies with Prudential's arguments to extend LAP and "level the playing field" between accountants and lawyers, the Supreme Court has returned firmly to the status quo and left any changes to Parliament alone.

Accountants should consider carefully the extent to which their conduct in providing legal advice and the privileges afforded to them differ from those of lawyers. It may be prudent to make clients aware of these limits at the outset in order to prevent difficult situations or complaints in the future. It is also worth noting the limited extent to which advice given by accountants to their clients will be protected from disclosure. Until further notice, it seems clear that accountants will generally be required to provide such information and documents as HMRC or others may require in keeping with their professional guidance and obligations.

AUDIT NEWS
Mandatory Audit Firm Rotation

The European Parliament's Legal Affairs Committee has voted in favour of a draft law that would require public-interest entities such as banks, insurance firms, and listed companies to rotate audit firms every 14 years and prohibiting the provision of certain non-audit services and ruling out Big Four-only contractual clauses.

The measures represent a watered down version of proposals we reported on in previous editions of this Update, which had called for a six year rotation period and a general ban on offering non-auditing services. Under the proposed rules, which mirror those set by the International Ethics Standards Board for Accountants, auditing firms would be able to continue providing certification of compliance with tax requirements, but they are to be barred from supplying tax advice which directly affects the company's financial statements and may be subject to question by national tax authorities. The 14-year rotation period can be extended to 25 years if certain safeguard criteria are met.

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HMRC penalties - reliance on negligent advice

In Waseem Shakoor v HMRC [2012] UKFTT 532 (TC) the First-tier Tax Tribunal considered whether negligent advice from an accountant was a defence to penalties imposed upon the taxpayer who relied upon that advice

The Facts

This was an appeal by Mr Shakoor against an assessment by HMRC to CGT in the sum of £49,014 plus a 70% penalty.

Mr Shakoor had purchased two properties in August 1999, neither of which he subsequently lived in. He sold both of the properties in July 2003 and realised a profit on the sales. However, Mr Shakoor did not declare the sales (or therefore the gains) in his self-assessment tax return, as his accountant had advised him that the gains were not taxable under the CGT principal place of residence exemption. As a result, upon discovery, HMRC sought recovery of the CGT and imposed a 70% penalty.

HMRC accepted that Mr Shakoor had not acted fraudulently but alleged that he had been negligent in failing to pay the CGT due.

Mr Shakoor argued that the penalty should be reduced to nil on the basis that he had relied upon the advice of his accountant and consequently had not acted negligently.

Decision

The Tribunal considered the decision in AB (A firm) v HMRC [2007] wherein it was established that a taxpayer who takes proper and appropriate advice to ensure that his tax return is correct, and subsequently acts in accordance with that advice (provided it is not obviously wrong), will not be considered to have acted negligently. The Tribunal concluded that this remained the correct approach and went on to conclude that if an accountant providing tax advice acts negligently then that negligence should not be imputed to the tax payer.

However, the Tribunal also considered the case of Wald v HMRC [2011] where a 10% penalty was imposed on a taxpayer who had (albeit honestly) negligently failed to declare expenses on his tax return, which had been prepared by his accountants.

In distinguishing the two cases, the Tribunal concluded that where a tax payer simply retains an accountant as an agent or functionary, and not as a 'professional adviser', the accountant's negligence is unlikely to be a defence. The Tribunal considered the scenario where a taxpayer fails to meet a deadline for filing a tax return due to the negligence of their accountant; in that case the accountant will simply be carrying out an administrative task and the taxpayer will not be able to rely on the accountant's negligence as a defence.

On the other hand, the Tribunal suggested that where a professional adviser is retained to provide professional advice based on the best of his skill and professional ability, this may provide the taxpayer with a defence, in accordance with the decision in AB (A firm) v Wald.

In this instance, Mr Shakoor admitted that when his accountant provided him with the tax return he noticed that there was no reference to the disposal of the properties. However, Mr Shakoor argued that when he had questioned this with his accountant, his accountant told him that the gain was exempt from CGT and he did not therefore seek any further clarification from his accountant.

Accordingly, the Tribunal held that Mr Shakoor knew he had not resided in either property and there must therefore have been, at the very least, reasonable doubt in his mind that the principal place of residence exemption could apply. The Tribunal considered that ultimately this was a case of "shutting one's eyes to what either was or ought reasonably to have been seen as incorrect advice".

On that basis, the Tribunal held that Mr Shakoor should pay a penalty of 30% as an appropriate assessment of his relative and relevant culpability.

Comment

It is clear that each case will be decided on its facts; however, where the accountant's role has gone beyond that of an 'agent' or 'functionary', in the sphere of tax advice, a client may be able to rely upon that advice in defending a claim for penalties from HMRC. Situations such as this can give rise to liability on the part of the accountant for penalties where the accountant is negligent. However, this decision (in addition to that in Wald v HMRC) provides a useful precedent in defending claims against accountants for penalties where the mistake was such that the client should have known that it was wrong.

> "HMRC sought recovery of the CGT and imposed a 70% penalty.

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HMRC offer to settle tax avoidance schemes

Towards the end of last year HMRC launched a fresh push to crack down on tax avoidance and you may have seen some of the resulting publicity. As part of this process, HMRC has been offering participants in certain schemes the opportunity to settle their tax liabilities without litigation and should by now have contacted all those who are eligible (http://www.hmrc.gov.uk/press/settle-opp-tax-avoid.htm). This opportunity is not open-ended and HMRC has threatened to accelerate its investigations into those who do not settle now.

HMRC is offering settlement to participants in the following four schemes:

- UK GAAP partnerships/corporates that attempt to create a loss through the write-off of expenditure or the value of rights or assets through Generally Accepted Accounting Practice;
- Partnerships that attempt to claim reliefs and allowances, for example in partnerships that invested in carbon trading;
- Film production partnerships that attempt to claim relief for expenditure incurred on the production of a qualifying British film under S.42 and 48 Finance Act (no.2) 1992; and
- Sole traders that attempt to create a loss through a self-employed trade that would involve substantial expenditure said to be incurred in the trade, or a write-off of expenditure or the value of rights or assets through Generally Accepted Accounting Practice.

HMRC is not offering settlement to participants in the following:

- Film partnership sale and lease back schemes;
- Interest relief schemes that result in a claim to interest relief under S353(1) ICTA 88 that is used as a deduction against general income;
- Partnerships into which HMRC has commenced criminal investigations;
- Any cases that are identified by HMRC during the course of an enquiry as falling within its criminal investigation policy or civil investigation of fraud procedure; and
- Cases that HMRC considers are inappropriate for this settlement opportunity, for example where HMRC considers that it has strong grounds to deny all of the tax relief claimed.

It is anticipated that these settlement opportunities will be of great interest to accountants and insurers of accountants whose clients are under investigation by HMRC for their involvement in one or more of the four eligible schemes above. This is especially so where the client has brought a related professional negligence claim against the accountant, or where circumstances exist such that a claim against the accountant is anticipated for such losses as the client may suffer in the course of HMRC's enquiry into their affairs.

> HMRC is currently offering participants in certain schemes the opportunity to settle their tax liabilities without litigation.

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