The Duty of Solicitors to Give Tax Advice: Recent Developments

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Do solicitors have a duty to advise their clients how best to avoid paying taxes? In Bayer v Balkin *(1995), a judge of the Supreme Court of New South Wales suggested that they do, but he later felt compelled to withdraw the suggestion. As a result the law has been left in some confusion. In this article a Perth QC clears up some common misconceptions regarding the duty of solicitors to give tax advice and comments on some recent cases which have dealt with this controversial issue.*

THE DUTY of solicitors to give tax advice to their clients has been confirmed in an English decision. In addition, an interesting decision of some relevance to this issue has been handed down by the Supreme Court of Western Australia. Both cases are considered in this article, together with a controversial decision of the Supreme Court of New South Wales, *Bayer v Balkin.*[1]

JUSTICE COHEN'S REMARKS IN BAYER v BALKIN

In his reasons for judgment in *Bayer v Balkin*, Cohen J of the Supreme Court of New South Wales made the following observation:

> It may once have been considered that it was the duty of citizens and residents of a country to make their proper contribution to the revenue so as to enable the

† Queen's Counsel. An earlier draft of this paper was published in *Brief* Vol 25 No 1 (Perth: WA Law Soc, 1998) 25, and also in *Tax Week* Issue 11 (Sydney: CCH, 1998) 117.

1. (1995) 95 ATC 4609.

> government to run the country for the benefit of its inhabitants. It now seems to be accepted, with the imposition of high rates of tax upon those who are most able to contribute to that revenue, that there is a duty on persons such as accountants and solicitors to advise their clients how they can avoid, as far as possible, making what the government regards as a proper contribution. That duty to advise has not been contested in these proceedings.[2]

In August 1996, I attended the Australian Bar Association conference in San Francisco. At the convention dinner, I found myself sitting next to a gentleman who turned out to be Justice Cohen of the Supreme Court of New South Wales. When I told him that I had recently read his judgment in *Bayer v Balkin*, and written an article about it,[3] he acknowledged that his remarks had caused some controversy in Sydney. He added that his comments about the duty to avoid tax were the only part of the long reasons for judgment which he had not supported by quoting authorities. This was because he regarded the point he was making as 'obvious', and thus not in need of further elaboration. He went on to say that he had subsequently requested the Public Information Officer of the Supreme Court to issue a press release in defence of his comments, with the result that a newspaper had written up his explanation on the basis that he was 'joking' when he made the comments in his reasons for judgment. He had therefore decided that in future he would not seek to explain his judgments publicly.

In July 1997, the Chief Tax Counsel of the Australian Taxation Office issued a statement in relation to the matter, part of which said as follows:

> These remarks [in the judgment of Cohen J] have been quickly picked up by some commentators. What has not been picked up is the public statement by the Supreme Court to the effect that the judge was speaking 'ironically'.
>
> The only reference to that statement that I [the ATO's Chief Tax Counsel] have found appears in the *Sun Herald* for 29 October 1995, as follows:
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> 'When he said last month that accountants and solicitors now appear to have a "duty" to advise their well-heeled clients on how to avoid paying taxes, the judge was speaking ironically. The tax-avoiding chicanery of lawyers and accountants is abhorrent to Justice Cohen, advised Ms Nelson [Public Information Officer of the Supreme Court of NSW] after reading last week's item headlined, "Legal View on Tax Avoidance".'[4]

The clear views expressed by Cohen J in his reasons for judgment have since been separately and independently reinforced in a recent English decision.

2. Ibid, 4617.
3. *Brief* Vol 2 No 6 (Perth: WA Law Soc, 1996) 17.
4. *Weekly Tax Bulletin* No 36 (Sydney: Aust Tax Practice, 1997) ¶ 965.

ENGLAND: *HURLINGHAM ESTATES v WILDE & PARTNERS*

The case in point is *Hurlingham Estates v Wilde & Partners,*[5] a decision of Lightman J in the Chancery Division of the High Court of Justice in England. The facts are as follows.

Hurlingham claimed damages against its former solicitors for breach of the contractual duty of care and the tort of negligence. The solicitors acted in a transaction involving the purchase of shares in a company, the purchase of a lease of shop premises and the grant of a sub-lease of the premises. The structure of the transaction, so far as it involved the purchase of the lease, the grant of the sub-lease and the payment of £200 000, resulted in Hurlingham being assessed for a tax charge totalling nearly £70 000. If a different structure had been adopted (as it could have been), exposure to this tax would have been avoided.

The issues were twofold: one of fact — namely, whether the solicitors, when they accepted instructions at a charge-out rate of £200 (A$450) per hour, obtained the agreement of the clients that their instructions should be limited by excluding any duty to advise on tax and that the clients should look elsewhere for tax advice; and one of law — namely, whether, in the absence of such a limitation on the duties they assumed, there was a duty on the part of the solicitors to advise or warn Hurlingham of its exposure, or the existence of the risk of exposure, to such a tax charge.

The charge arose under section 34(1) of the Income and Corporation Taxes Act 1988 (UK) which provided, in effect, that where a lessee paid a premium under a lease for a duration of less than 50 years, the landlord should be treated for tax purposes as becoming entitled to an additional amount of rent calculated under a statutory formula by reference to the amount of the premium. In the present case, although the £200 000 was paid for a mixture of three purposes, the Inland Revenue, having regard to the structure of the transaction, treated the full £200 000 as additional rent which gave rise to the £70 000 tax charge. Hurlingham accepted that the assessment by the Inland Revenue was correctly made.

The reasons for judgment of Lightman J are so relevant and pertinent to solicitors generally that it is worthwhile quoting them at length. The first remarkable feature of the case to which the judge drew attention was this:

> Mr Rowe, who was at the material time the conveyancing and commercial partner of the solicitors —

5. [1997] 1 Lloyd's Rep 525.

(1) had (as he told me) next to no knowledge of tax law and was quite unqualified to give tax advice or to appreciate, or give any warning as to, the existence of any risk of any adverse tax consequences in any transaction, save on the simplest sale of residential property; and

(2) was unaware of the provisions of rule 6 of the then current Solicitors' Practice Rules 1988, prohibiting solicitors accepting instructions from two or more clients where there is a conflict of interest between them.

> There was accordingly no appreciation on his part of the tax risks involved in the transaction, or that there plainly was (in respect of the transaction relating to the premises) an objectionable conflict of interest between the clients....
>
> Since the practice of conveyancing and commercial law must necessarily involve time and again considering the tax implications of proposed transactions and decisions, I find it difficult to comprehend how a solicitor possessed of no real knowledge of tax law can be allowed to occupy such a position, at any rate in a case such as the present where he does not have the necessary tax law back-up; certainly it must be questionable whether he should be allowed to do so if any regard is to be paid to the safety of the public.[6]

The second remarkable feature discussed by Lightman J dealt with the extent to which it is necessary to record any agreement with a client that the tax advice, which could ordinarily be expected to be provided, will not be provided. The judge said:

> There is no written record of the alleged (but disputed) agreement to limit the solicitor's duties. Any such agreement must plainly, if it is to have any legal effect, be clear and unambiguous: the client must be fully informed as to the limited reliance he may place on his solicitor and the reason for it (ie, the solicitor's lack of any basic knowledge or competence), that this limitation is not a normal term of a solicitor's engagement, and that the client may be better advised to go to another solicitor who is not so handicapped and can be retained with no such limitation on his duties. Common sense requires that all these matters should also be recorded in an attendance note of the meeting where they are discussed and agreed, and should subsequently be recorded in a letter to the client. The letter is required, not merely to evidence what has been agreed but to ensure that, after receipt of the letter, the client can consider (and discuss with others) the position and its implications away from, and free from any constraints imposed by, the presence of the solicitor. These are elementary precautions to ensure that the client gives a fully informed consent to a potentially disadvantageous arrangement when there is an obvious potential conflict between the interest of the solicitor (in retaining his client's work) and the client (in obtaining the best, or at least competent, service and advice).[7]

6. Ibid, 526.
7. Ibid.

Lightman J was satisfied that there was no such agreement limiting the solicitor's duties. Mr Rowe, the solicitor, assumed the full role in the transaction and the responsibilities to be expected of a solicitor having the conduct of it. However, the judge went even further:

> I should add that even if (contrary to my holding) the clients had at the meeting entered into some such agreement as suggested by Mr Rowe that he be retained subject to a limitation on his remit, I doubt if he could have established that there was any fully informed consent on the part of the clients. Conspicuously, he failed to tell them that the lacuna in his legal knowledge was not one to be expected of a solicitor having the conduct of a transaction such as that now to be undertaken by him on their behalf and that the clients' interest might (indeed did) require them to instruct another solicitor who was competent and would not need to insist on such a limitation on his services and duties.[8]

In deciding the issue of law, Lightman J stated:

> There were no specific terms of the solicitors' retainer limiting what would be the ordinary duty of a solicitor instructed on such a transaction. There was no specific reference to tax on 29 May 1991 [the date of the original instructions], but that does not mean that Mr Rowe did not assume responsibilities to advise as to tax. There was no reason or justification for Mr Rowe assuming that Hurlingham would be seeking any taxation advice on the transaction from its accountants or auditors or anyone else and Mr Rowe had no reason to believe that Hurlingham was possessed of any expertise in matters of taxation: everything was placed in Mr Rowe's (apparently safe) hands. Mr Rowe should have appreciated (and I think did appreciate) that Hurlingham needed his advice and services to avoid any unnecessary tax risk, a risk the existence of which would necessarily elude them. In these circumstances I have no doubt that he owed a duty to advise how the transaction should be structured, and to advise that the structure in fact adopted exposed Hurlingham to the tax charge, which (by common consent) by alterations to the form rather than the substance of the transaction could have been avoided.[9]

It is worthy of note that, in the last sentence of this passage , the judge extended a solicitor's duty to advising how to minimise or avoid tax by changing the 'form' of a transaction, despite its 'substance'.

In conclusion, Lightman J gave judgment for Hurlingham for the sum claimed. He stated:

> I hold that Mr Rowe without any 'health warning' to Hurlingham accepted instructions and acted in a matter in respect of which (as he knew) he was unfit and unqualified to act and by reason of his negligence occasioned to Hurlingham

8. Ibid, 529.
9. Ibid, 530.

> the avoidable loss in respect of which Hurlingham claims recovery. Hurlingham is accordingly entitled to recover by way of damages the loss and incidental costs incurred together with interest.[10]

There is no reason why the decision in *Hurlingham Estates*[11] should not, and would not, be fully adopted and applied in Australia. Everything which Lightman J said as to the duty of solicitors has equal application to practitioners in this country. Practitioners are therefore warned that it is their duty in acting for clients in transactions which could create a potential tax liability –

(a) to structure the transaction in such a way as to avoid that liability; or
(b) if they are unable to give such advice themselves, either
    (i) to tell the client to instruct some other competent solicitor; or
    (ii) to seek the assistance of another practitioner (eg, a tax partner in the same firm or a barrister) who can provide that tax advice.

WESTERN AUSTRALIA: *BRIAR HOLDINGS v CAPOLINGUA*

An indication of the type of case which may arise is given by the facts in a case recently decided by Master Bredmeyer of the Supreme Court of Western Australia in *Briar Holdings v Capolingua*.[12] Although the defendant in that case was an accountant, exactly the same issue could arise for a solicitor. A partnership (consisting of Mr and Mrs Kommer, Mr Milner and another) retained Mr Capolingua as their accountant and tax agent. The partnership approached Capolingua for advice on a proposal by Capolingua that the partnership transfer its business to a company. Capolingua was requested to advise on the financial and taxation consequences of the transfer. It was pleaded that it was a term of the retainer that Capolingua would advise them with a reasonable degree of skill and care as to how to minimise their tax exposure and the best structure for their affairs from a tax perspective. It was also pleaded that Capolingua owed the partnership a duty of care to that effect.

Capolingua advised the partners to acquire a shelf company, become directors and shareholders of the company and sell their business to the company. The partners accepted that advice, a shelf company (Briar Holdings) was acquired and the partners became the directors and shareholders of that company. The assets of the partnership were sold to the company at a purchase price which was an unsecured

10. Ibid.
11. Ibid.
12. (Unreported) WA Sup Ct 25 July 1997, no 970368.

debt payable by the company upon demand by members of the partnership. By suggesting this course, the accountant turned the business, a capital gains tax-exempt asset, into a post-CGT asset.[13]

The company and the former partners pleaded that Capolingua breached his contractual retainer and his tortious duty to exercise reasonable skill and care in carrying out this transaction in that he failed to structure the transaction so as to obtain the 'rollover' relief provided in section 160ZZN of the Income Tax Assessment Act 1936 (Cth). It was pleaded in the alternative that he failed to give an election notice to the Commissioner of Taxation for the purposes of taking advantage of that relief, as prescribed by sections 160ZZN(2)(h) and (13). It was further pleaded that Capolingua failed to refer the partners to an experienced accountant or solicitor for advice on the tax consequences of the transfer.

Section 160ZZN gives rollover relief on the transfer of an asset from individual taxpayers to a wholly-owned company. It provides that where a taxpayer owns a pre-CGT asset and disposes of that asset to a company under certain conditions, then the company is also deemed to have acquired the asset before 20 September 1985 (ie, the company is deemed to have acquired a CGT-free asset). The conditions for such a transfer are these:

- the taxpayer sells the asset to the company;
- the consideration for the disposal is to consist only of shares in that company;
- the taxpayer is to become the beneficial owner of all the shares in the company; and
- the taxpayer is required to give notice in writing to the Commissioner of Taxation on or before the day of lodgement of his tax return for the year in which the disposal takes place, or within such further period as the Commissioner allows, of his/her election to apply section 160ZZN to the disposal.

The section applies to individual taxpayers and partners. Where partners who own pre-CGT assets sell those assets to a company, the ex-partners have to own all the shares in the new company, and each ex-partner has to hold the shares in the company in the same proportions as he/she held his or her interest in the partnership. The partners have to elect that the section is to apply to them by notifying the Commissioner in the manner stated.

The case came before Master Bredmeyer by way of an application by Capolingua to dismiss the plaintiffs' action under Order 20, Rule 19 of the Rules of the Supreme Court (WA), and/or under the inherent jurisdiction of the court, for failing to disclose any reasonable cause of action.

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13. A 'post-CGT asset' is one which is acquired and disposed of on or after 20 Sept 1985: Income Tax Assessment Act 1936 s 160L(1).

Capolingua succeeded in having the action dismissed. It was unnecessary for the Master to consider the substantive tort and contract liabilities. Generally, an assessable capital gain does not arise until the asset is realised (ie, 'disposed of').[14] The Master held that the loss of the opportunity for future rollover relief was, at the present time, entirely speculative. No loss or damage had yet been suffered by the plaintiffs and hence their causes of action in contract and tort were not complete. The loss of the CGT-free status was not itself a loss or damage. It was a hypothetical loss only, and not a sufficient actual loss to enable the court to engage in the exercise of examining the loss of an opportunity in assessing the quantum of damages. In principle, the court would not embark on an enquiry into what the plaintiffs' loss or damage might be if they were to sell the business or the shares for a gain at some time in the future. Master Bredmeyer concluded that that was speculative, hypothetical and a waste of the court's time and resources. If and when the plaintiffs sold the business or their shares, that would be the appropriate time to bring the action.

The plaintiffs' alternative argument, that they were entitled to a declaration that Capolingua was liable to indemnify them in respect of any capital gain which might be included in their assessable income as a result of disposing of the business or the shares at some future time, was also rejected by the Master. Whether the plaintiffs sell their business or shares in the future and make a gain subject to CGT is hypothetical. If and when they do sell at a gain, the plaintiffs can sue the defendant in negligence for damages.

Master Bredmeyer held that the plaintiffs' causes of action were not time-barred because they were not yet complete. It is only when the business or the shares are sold at a profit, and CGT is incurred, that the causes of action will crystallise. Far from being time-barred, the six year time period has not yet commenced to run. In dismissing the action, he held that the plaintiffs would be free to bring a similar action in the future if and when they sold their business or the shares at a capital gain.

CONCLUSION

Clearly, the position is that solicitors have a duty to advise their clients on the tax aspects of whatever matter they are acting in. Alternatively, they must obtain from another tax-competent practitioner the necessary specialist tax advice for the benefit of the client. Failure to do this could result in the solicitors being held liable to the client for negligence and/or breach of contract.

14. Income Tax Assessment Act 1936 ss 160Z(1), (2) and 160ZQ(1).