The Civil Liability of the Tax Specialist

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INTRODUCTION

This paper deals in a very summary way with the civil liability of the tax specialist in Canada and particularly in Alberta. By tax specialist, I mean generally chartered accountants and lawyers who practice in the area of taxation and who are in private practice. I shall also refer briefly to the liability of the “in-house” tax advisor. Civil liability refers to the liability that the tax specialist has to his client and to third parties who may rely upon the tax specialist's work. This paper does not deal with the professional responsibilities of the tax advisor which are enforced by the professional governing bodies such as The Law Society of Alberta and The Institute of Chartered Accountants of Alberta.

In Canada we have very few reported decisions concerning liabilities arising out of the giving of tax advice. By contrast, there is a large and ever growing body of Canadian law pertaining to the liability of solicitors generally and to the liability of accountants arising out of the performance of an audit. Therefore we are able to make some broad statements about the liabilities of tax advisors by applying the general principles that have developed in cases dealing with the liability of solicitors and auditors.

The Tax Advisor's Duty of Care

If you are engaged for the purposes of tax planning, giving an opinion, preparing a return or performing any other service that tax specialists provide, you owe a duty of care to your client and possibly to others. You may be liable to your client and to others should you fail to fulfill that duty of care.

The standard of care which a tax specialist must meet, in discharging his or her professional responsibilities, is the standard which applies to professional persons generally. That standard has been considered by the Courts in many decisions dealing with accountants and solicitors.

In 1986 the Supreme Court of Canada reviewed the standard of care for a solicitor in Central Trust Co. v. Rafuse et al. This 64 page judgment, which is a scholarly treatise written by Justice Le Dain, is a leading decision in the area of solicitor's negligence, concurrent liability in contract and tort and limitation periods. Each of those topics is relevant to the question of the tax advisor's liability.

The facts of the case were briefly that Central Trust had retained solicitors to prepare a mortgage to secure a loan. When the mortgagors defaulted on the mortgage Central Trust attempted to enforce its security. At that time they were met with a defence that the mortgage was void in light of certain provisions of the Nova Scotia Companies Act. Litigation ensued with regard to the validity of the mortgage. At trial, two experienced solicitors gave conflicting expert evidence with respect to whether or not a solicitor would be expected to be familiar with the relevant provision of the Companies Act. The Nova Scotia Supreme Court, Trial Division, held that the mortgage was not void. On appeal, both the Nova Scotia Supreme Court, Appeal Division, and the Supreme Court of Canada found that the mortgage was void. Accordingly, the Trial Judge and the Appellate Courts held different views with regard to the validity of the mortgage. The Defendant solicitors took the position that since there was conflicting expert and judicial opinion with regard to whether the mortgage was enforceable, they had not been negligent in drafting the mortgage.

The Supreme Court of Canada defined in broad terms the standard of care of a solicitor, as follows:

> A solicitor is required to bring reasonable care, skill and knowledge to the performance of the professional service which he has undertaken....The requisite standard of care has been variously referred to as that of the reasonably competent solicitor, the ordinary competent solicitor and the ordinary prudent solicitor.

(p. 167)

The Supreme Court then went on to deal with the extent to which a solicitor is required to know the law:

> The requirement of professional competence that was particularly involved in this case was reasonable knowledge of the applicable or relevant law. A solicitor is not required to know all the law applicable to the performance of a particular legal service, in the sense that he must carry it around with him as part of his “working knowledge”, without the need of further research, but he must have a sufficient knowledge of the fundamental issues or principles of law applicable to the particular work he has undertaken to enable him to perceive the need to ascertain the law on relevant points.
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> (p. 167)

Further in connection with the duty to know the law, Justice Le Dain referred to and quoted from three textbooks:

> "An attorney is expected to possess knowledge of those plain and elementary principles of law which are commonly known by well-informed attorneys, and to discover those additional rules of law which, although not commonly known, may readily be found by standard research techniques." (7 Am. Jur. 2d, "Attorneys at Law")
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> "Although a solicitor is not bound to know the contents of every statute of the realm, there are some statutes, about which it is his duty to know. The test for deciding what he ought to know is to apply the standard of knowledge of a reasonably competent solicitor." (Charlesworth and Percy on Negligence, 1983)
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> "Although a solicitor is not 'bound to know all the law', he ought generally to know where and how to find out the law in so far as it affects matters within his field of practice. However, before the solicitor is held liable for failing to look a point up, circumstances must be shown which would have alerted the reasonably prudent solicitor to the point which ought to be researched." (Jackson and Powell, Professional Negligence, 1982)

I would suggest that the standard of care enunciated by the Supreme Court of Canada in Central Trust Co. v. Rafuse et al would apply to professional persons practicing in the area of tax law, be they lawyers or accountants. The standard of care for professional persons in general was defined by Lord Diplock of the English House of Lords in 1978 in Saif Ali v. Sidney Mitchell & Co., a case of barrister's negligence, as follows:

> Those who hold themselves out as qualified to practice other professions, although they are not liable for damage caused by what in the event turns out to have been an error of judgment in some matter upon which the opinions of reasonably informed and competent members of the profession might have differed, are nevertheless liable for damage caused by their advice, acts or omissions in the course of their professional work which no member of the profession who was reasonably well-informed and competent would have given or done or omitted to do.
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> (p. 1041)

It is clear from a review of the aforementioned tests for the appropriate standard of care that an error does not necessarily constitute conduct which does not meet the required standard of care and which might therefore give rise to liability. In the absence of any specific guarantees or warranties, the law does not impose a requirement upon a professional person that his or her work be performed without error. That in essence was one of the defences raised by the solicitors in Central Trust Co. v. Rafuse et al, wherein they argued that they could not have been expected to know that the mortgage which they drew was void, as the Supreme Court of Canada ultimately ruled.

In other words, a mere error does not necessarily give rise to liability to your client. This point was best expressed by the famous English Judge, Lord Denning, in a 1980 decision dealing with alleged medical malpractice, Whitehouse v. Jordan, wherein Lord Denning stated:

> ...the (trial) judge required Mr. Jordan to come up to "the very high standard of professional competence that the law requires". That suggests that the law makes no allowance for errors of judgment. This would be a mistake. Else there would be a danger, in all cases of professional men, of their being made liable whenever something happens to go wrong. Whenever I give a judgment, and it is afterwards reversed by the House of Lords, is it to be said that I was negligent? That I did not pay enough attention to a previous binding authority or the like? Every one of us every day gives a judgment which is afterwards found to be wrong. It may be an error of judgment but it is not negligent....We must say, and say firmly, that in a professional man, an error of judgment is not negligent.
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> (p. 658)

In determining the appropriate standard of care which the tax specialist must adhere to, one must also consider the guidelines and standards which have been established by the professional governing bodies throughout Canada and the United States. A failure to meet the standards established by the professional governing bodies does not necessarily constitute negligence. The standards, such as those set out in the C.I.C.A. Handbook, are often styled as "recommendations" and are not a statutory codification of the standard of care. However, I have no doubt that a Court would be heavily influenced by evidence that a Chartered Accountant or a lawyer failed to live up to standards which their respective professions had established.

With regard to the standard of care applicable to the Chartered Accountant engaged in a tax practice, you should consider the Statements on Responsibilities in Tax Practice, which have been developed under the auspices of the American Institute of Certified Public Accountants (the "A.I.C.P.A.") and which are published with the A.I.C.P.A. Professional Standards. The Statements constitute a body of advisory opinion on good standards of tax practice and the appropriate standards of responsibility in tax practice. The Statements focus largely on the responsibilities involved in the preparation of tax returns, but also deal with the giving of tax advice to the client. While these Statements pertain to the accounting profession in the United States, I would expect that many of the principles contained therein are of broad application and may be relevant to Canadian tax practitioners.

It seems reasonable to expect that a higher standard of care will be required of a professional who has developed a specialty or who has greater experience in a particular field and who holds himself out to the public as such. The specialist standard has certainly been applied in medical malpractice cases. This issue was considered by the English Chancery Division in Duchess of Argyll v. Beuselinck, This was an action against a solicitor who allegedly failed to properly advise the Duchess with regard to the tax consequences arising out of the publication of her memoirs. Mr. Justice Megarry addressed the question of what the applicable standard of care was for a solicitor who was an expert, as follows:

> But if the client employs a solicitor of high standing and great experience, will an action for negligence fail if it appears that the solicitor did not exercise the care and skill to be expected of him, though he did not fall below the standard of a reasonably competent solicitor? If the client engages an expert, and doubtless expects to pay commensurate fees, is he not entitled to expect something more than the standard of the reasonably competent? I am speaking not merely of those expert in a particular branch of the law, as contrasted with a general practitioner, but also of those of long experience and great skill as contrasted with those practicing in the same field of law but being of a more ordinary calibre and having less experience. The essence of the contract of retainer, it may be said, is that the client is retaining the particular solicitor or firm in question, and he is therefore entitled to expect from that solicitor or firm a standard of care and skill commensurate with the skill and experience which that solicitor or firm has.
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> (p. 183)

In a recent Ontario case, Elcano Acceptance Ltd. et al v. Richmond et al, a Justice of the Ontario Supreme Court stated that while the legal profession lacked a formal specialization, the time was at hand to recognize de facto specializations. Accordingly, the Court adopted an approach that recognized a distinction between a specialist and general practitioners in defining the standard of care for a solicitor. Therefore the standard of care applied was that of a reasonably competent specialist. (This case was appealed to the Ontario Court of Appeal and a new trial was ordered on other grounds. The Court of Appeal did not comment on the specialist standard of care which the Judge had adopted.)

The standard of care may also vary according to the locality in which the professional practices. This principle has been enunciated in two decisions of the English Privy Council, being Stephens et al v. Allen, and Edward Wong Finance Co. Ltd. v. Johnson Stokes & Master. Both of these cases were actions against solicitors. In the Stephens case, the Privy Council stated that:

> The question of negligence with regard to the performance of a solicitor's duty must to some extent be affected by the local conditions and the local circumstances....
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> (p. 267)

This concept of the local standard of care has been applied in Canadian cases involving solicitors negligence and medical malpractice. However, the principle that the standard of care varies according to local conditions had greater application in years gone by, when Courts were called upon to compare the practices of solicitors who were practicing under English law in far flung corners of the globe. In modern times, given the advances that have been made in communications and transportation and the efforts of the professional governing bodies to maintain its members' level of competence, it should be expected that the Courts will give less weight to the local practice in determining the appropriate standard of care. I would expect that this would be particularly true with regard to the tax specialist, most of whom practice in the larger urban centres of Canada.

It should also be recognized that the tax specialist has a duty to consult with other specialists in the event that he accepts an engagement which involves matters outside of his area of expertise. In other words, you should recognize the limits of your specialization and competence and know when to look elsewhere for advice. A recent Canadian case illustrates this point in the context of the duties of a Chartered Accountant who was retained to act as a Receiver-Manager. In Doncaster v. Smith, a 1987 decision of the British Columbia Court of Appeal, the Defendant accountant was appointed as Receiver-Manager of three related companies. The Receiver-Manager decided to sell a motel which was the principal asset of one of the companies. As a result of this sale there was a significant tax liability arising out of capital gains and recaptured depreciation. The accountant failed to recognize that he should have taken steps to amalgamate the three companies prior to the sale, since the other two companies had suffered losses. He thought, incorrectly, that the losses could be applied against the capital gains and recapture if amalgamation took place any time prior to the income tax returns being filed. The Court held that the accountant was liable to his client. In coming to that conclusion, the British Columbia Court of Appeal stated that the Receiver-Manager had a duty to seek the appropriate tax advice, as follows:

> In my respectful opinion the primary obligation rests on the receiver-manager to seek such powers as he considers necessary to perform his duty in the circumstances. If the receiver-manager in the present case had acted in a timely fashion and sought appropriate tax advice at the time he decided to sell the Travelodge, he would have been advised that he could reduce the tax liability of Motel. He could then have applied to the court for authority to amalgamate the companies. As he was aware that Motel was making a capital gain and recapturing depreciation, the defendant was under an obligation to seek tax advice prior to completing the sale. Instead, he chose to proceed without the benefit of such advice and as a result Motel was unable to minimize the amount of tax for which it was liable.
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> (emphasis added, p. 62)

Does the Duty of Care Arise in Contract or in Tort?

The law recognizes a distinction between a cause of action arising in contract and a cause of action arising in tort. Generally speaking, contractual liabilities are those which the parties to a contract expressly or impliedly agree to. Tortious liability, which encompasses the concept of negligence, is imposed by the law and is independent of any express or implied agreement between the parties.

Whether the liability of a tax advisor to his client arises in contract or in tort, or both, has little bearing on the standard of care which the Court will impose, in the absence of any specific agreement as to the appropriate standard of care. However, whether liability arises in contract or tort does have significance with regard to such matters as the applicable limitation period, the measure of damages and whether the concept of contributory negligence can be applied.

Whether an action against a professional person for malpractice arises in contract or in tort has been the subject of conflicting judicial opinion in Canada for many years. However the ongoing debate in this area was finally resolved by the previously mentioned decision of the Supreme Court of Canada in Central Trust Co. v. Rafuse et al. At that time the Supreme Court of Canada followed the lead of American Courts and held that normally there was concurrent liability in both contract and tort for breaching the duty of care in the performance of professional services.

The issue of whether the liability arose in contract or in tort was relevant in Central Trust since it was conceded that the limitation period for bringing an action against the solicitors had expired in contract. Therefore Central Trust's cause of action against the solicitors was barred by the passage of time unless Central Trust could also claim in negligence, in which case different principles would apply to the calculation of the limitation period.

After an exhaustive review of all of the relevant authorities, Justice Le Dain concluded that:

(1) There is a common law duty of care (in tort) that arises out of certain relationships and which is not confined to relationships which arise apart from a contract. In other words, the duty of care includes contractual and non-contractual relationships.

(2) The duty of care in tort does not depend on specific obligations or duties created by the express terms of a contract. It is independent of the contract.

(3) However a liability in tort will not form the basis for circumventing or escaping a contractual exclusion or limitation of liability. This is particularly relevant to tax advisors who expressly qualify their opinions.

(4) The principle of concurrent liability in contract and in tort applies to solicitors just as it applies to other professionals.

The Tax Advisor's Duty to Third Parties

Lawyers and accountants have been held to owe a common law duty of care to third parties who are not their client and with whom they are not in contract. This duty has developed outside of the field of tax law. However if tax advisors perform services with knowledge that third parties will rely upon those services, then tax advisors may owe a duty of care to those third parties. Third party reliance might, for example, arise in the context of the rendering of an opinion on the offering of securities to the public.

Apart from the common law duty of care, there is a statutory duty of care established by virtue of certain provisions of the Securities Act, S.A. 1981. Part 16 of that Act gives a purchaser of securities a right of action for damages against the issuer, the underwriter, directors of the issuer, and those persons whose consent has been filed pursuant to the Securities Act regulations with regard to reports, opinions, or statements which have been prepared by them. That latter group would include chartered accountants, who bear liability with regard to the financial statements, and lawyers, who bear liability with regard to any opinions expressed in the prospectus and in particular, with regard to the summary disclosure of significant income tax consequences required by the Securities regulation.

While there is a statutory cause of action given to third parties pursuant to the Securities Act, it should be borne in mind that that cause of action pertains generally to a “misrepresentation” as defined by the Securities Act. Tax specialists who prepare reports, opinions or statements for inclusion in a prospectus should recognize that they may have a common law liability to third parties for conduct which does not meet the common law standard of care but which does not constitute a misrepresentation within the meaning of the Act.

The notion that a solicitor could be liable in common law to third parties who are not his client developed in cases involving wills, wherein beneficiaries under a will commenced action against the testator's solicitor in circumstances when the will was invalid as a result of the solicitor's negligence. In earlier decisions the concept of privily of contract had barred any successful claim by beneficiaries who were not in contract with the solicitor.

However in 1961, the Supreme Court of California in Lucas v. Hamm overruled earlier authority and held that the lack of privily between the beneficiaries and the solicitor who prepared the will did not preclude an action against the solicitor for negligence. The Court set out the factors which would bear on whether a solicitor had a liability to a third party:

> ...whether in a specific case the defendant will be held liable to a third person not in privity is a matter of policy and involves the balancing of various factors, among which are the extent to which the transaction was intended to affect the plaintiff, the foreseeability to harm to him, the degree of certainty that the plaintiff suffered injury, the closeness of the connection between the defendant's conduct and the injury, and the policy of preventing future harm.
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> (p. 687)

Lucas v. Hamm was followed by other American decisions which opened the door to claims by beneficiaries against solicitors. Such claims have now been permitted in Canadian jurisdictions. The same issue was recently considered in England in Ross v. Caunters. In that case the Court rejected the argument that a solicitor could not be liable in negligence in relation to his professional work to anyone other than his client.

The liability of accountants to third parties has been the subject of a great deal of comment and discussion in recent years. This has occurred largely as a result of the breaking down of the barriers which the doctrine of privily of contract had placed in the way of a claim by a third party against an accountant. The law in this area has developed almost entirely in the context of the preparation of audited financial statements. While there have been a number of significant reported decisions, I will refer to two American cases and two Canadian cases which are illustrative of the changes that have occurred in the law.

Ultramares Corporation v. Touche is a landmark decision from the New York Court of Appeals. The facts of that case were briefly that the accountants were employed by a company to perform the annual audit. Upon the completion of the audit, the accountant supplied the company with 32 certified copies of the financial statements. The audit reported assets of over $2.5 million and a net worth exceeding $1 million. In fact, the company was insolvent. After completion of the audit, the company approached the plaintiff Ultramares Corporation and obtained a loan of $160,000. In deciding to make the loan Ultramares reviewed the certified copies of the financial statements and relied upon them. Following the bankruptcy of the company, Ultramares sued the accounting firm on the basis of negligence. It is important to note that there was no contractual relationship between the accountants and Ultramares.

The New York Court of Appeals dismissed the action in negligence against the accountants. In a now famous passage, Justice Cardozo took the view that the accountants owed no duty to the public, as follows:

> If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a inability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.
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> (emphasis added, p. 444)

Over 50 years later the same New York Court of Appeals extended the liability of accountants to third parties in Credit Alliance Corporation v. Arthur Andersen CO., Briefly the facts of that case were that Credit Alliance extended financing to a company in reliance upon inaccurate audited financial statements prepared by Arthur Andersen. Shortly thereafter the company filed for bankruptcy and the lender sued the accountants in negligence for losses of approximately $9,000,000. In finding for the lender Credit Alliance Corporation, the New York Court of Appeals took note of evidence that Credit Alliance was one of only eight companies that could have been the source of the financing required by the company. The Court held that the accountants would be liable to those whose reliance upon the financial statements should have been specifically foreseen by the accountants. The extent of the accountants' liability is discussed in the following terms:

> Generally, accountants are not liable to those members of the general public, who receive their reports, but with whom they do not have a contractual relationship (Ultramares Corp. v. Touche, 255 N.Y. 170, 174 N.E. 441). However, we find that, based upon the record, in the instant case the plaintiffs, despite not having a contract, or being in direct privily with defendant, are entitled to a duty of care from defendant because they are members "of a limited class whose reliance on [defendant's] audit...was, or at least should have been, specifically foreseen [by defendant]..."
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> Therefore, we hold that where defendant negligently prepares a financial statement, and it may reasonably be assumed that this statement was intended to induce plaintiffs to rely thereon, to plaintiffs' detriment in consequence of such reliance, and the plaintiffs sustain damages as a result of such reliance, the plaintiffs may recover - assuming, of course, that it is established that defendant's conduct was a substantial factor in causing such damages.
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> (p. 542)

While the New York Court of Appeals did not go so far as to embrace a reasonable foreseeability test, as other U.S. Courts have done in recent years, the Court did recognize that a departure from the privily doctrine was necessary in light of the changing nature of the accounting profession over the last 50 years and also in light of securities legislation which imposes upon accountants a reasonable duty of care to large bodies of persons.

The Supreme Court of Canada has also accepted that accountants owe a duty of care to certain third parties who are not their clients. The leading decision in this regard is Haig v. Bamford. The facts of the case are that a company, which was in need of additional capital, retained accountants to prepare audited financial statements. The accountants knew, prior to the completion of their financial statements, that the statements would be used by the company and by its bank with a view to seeking a potential investor in the company. In reliance upon the statements the plaintiff, a businessman, purchased an interest in the company. The financial statements had shown a profitable position but had been prepared in error. In fact the company was in difficult financial circumstances and ceased to carry on business shortly thereafter. The investor sued the accountants in negligence.

The Supreme Court of Canada had some words with regard to the changing role of the accountant and increased responsibility of the accountant to the public:

> The increasing growth and changing role of corporations in modem society has been attended by a new perception of the societal role of the profession of accounting. The day when the accountant served only the ownermanager of a company and was answerable to him alone has passed. The complexities of modem industry combined with the effects of specialization, the impact of taxation, urbanization, the separation of ownership from management, the rise of professional corporate managers, and a host of other factors, have led to marked changes in the role and responsibilities of the accountant, and in the reliance which the public must place upon his work. The financial statements of the corporations upon which he reports can affect the economic interests of the general public as well as of shareholders and potential shareholders.
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> (p. 74)

The Supreme Court reviewed three possible tests that it could apply to determine the extent of an accountant's duty of care to third parties, as follows:

> (i) foreseeability of the use of the financial statement and the auditor's report thereon by the plaintiff and reliance thereon; (ii) actual knowledge of the limited class that will use and rely on the statement; (iii) actual knowledge of the specific plaintiff who will use and rely on the statement. It is unnecessary for the purposes of the present case to decide whether test (i), the test of foreseeability, is or is not, a proper test to apply in determining the full extent of the duty owed by accountants to third parties. The choice in the present case, it seems to me, is between test (ii) and test (iii), actual knowledge of the limited class or actual knowledge of the specific plaintiff. I have concluded on the authorities that test (iii) is too narrow and that test (ii), actual knowledge of the limited class, is the proper test to apply in this case.
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> (p. 75)

Therefore in summary, the Court held that accountants owe a duty of care to the limited class who the accountants actually know will rely upon the accountants work. This is not as broad a test as has been applied in the United States.

There is a recent Canadian case which is worthy of note. In a 1987 decision of the British Columbia Supreme

Court, HongKong Bank of Canada v. Touche Ross & Co. it was held that the defendant accountants were liable to the bank for losses which the bank incurred on loans to a company which the accountants audited. The accountants' negligence, which was admitted by Touche Ross, arose out of the accountants' failure to note, in annual audits over a four year period, that the company had failed to remit federal sales tax. The evidence of the bank's loan officer was that he would not have made the loan if he had knowledge of the tax liability.

While this case deals with the liability of an auditor to a third party, it is distinguishable in that the accountants were also auditors of the bank. Thus, the auditors' duty of care to the bank arose in circumstances where the auditors had direct dealings and a direct contractual relationship with the bank. However the report of the case is not clear with regard to the extent to which the auditors may have been retained by the bank to advise them concerning the loan. It would appear from the report that the auditors did little more than introduce the bank to the borrower and generally recommend the borrower to the bank.

The Application of the Standard of Care

Whether or not a tax advisor is negligent and/or in breach of his contract to provide professional services turns upon the application of the standard of care to the facts of each individual case. There are very few reported Canadian decisions dealing with the issue of the civil liability of the tax advisor. There are however a number of reported American cases. Many of the reported U.S. decisions turn upon the interpretation of the applicable limitation period, that being the only real defence available to the tax advisor in the circumstances of the case. Some cases involve clear-cut errors or omissions. The following is a brief summary of two U.S. Cases and one Canadian case which may be of interest to the tax practitioner.

One of the leading American decisions is Bancroft v. Indemnity Insurance Co. of North America. This was an action against the professional liability insurers of a CPA who in 1955 had advised the Plaintiff with regard to a plan to sell stock from one corporation to another, both of which were owned by the taxpayer. The accountant advised the taxpayer that no federal or state tax would be payable on the sale of the stock. Accordingly, the taxpayer proceeded to sell the shares in two separate transactions, one in 1955 and another in 1957. The taxpayer was audited in 1959 by the IRS, who took the position that the sale of the shares constituted a redemption of stock and that the proceeds of sale would have to be included in income as dividends. The accountant admitted that he had missed a new law which had been enacted in 1954 and which governed the transaction. The accountant had acted on behalf of the taxpayer since 1938.

The Court first dealt with the argument that the taxpayer's action was premature since the taxpayer had not exhausted all remedies with the IRS. This argument was dismissed in light of evidence that the defendant accountant and another accountant retained by the taxpayer were both of the view that the tax was properly payable. The taxpayer had been advised that he would be unsuccessful if he attempted to pursue the matter further with the IRS. Accordingly, the Court found the taxpayer had acted reasonably in discharging his obligation to mitigate his losses.

The accountant's insurers also defended on the basis that the taxpayer was not justified in relying upon the accountant's written opinion which had been delivered some four months prior to the first stock sale and approximately forty-nine months prior to the second. The argument appears to have been to the effect that the opinion was too dated. The Court dealt with that argument in this fashion:

> We find that plaintiffs were reasonable in their belief that the advice given four months earlier was correct and still reliable when the first sale occurred.
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> Not having been challenged about the first transaction by I.R.S., plaintiffs understandably followed the identical procedure in selling the stock in 1957. The insured having been retained as plaintiffs' C.P.A. and tax consultant for approximately seventeen years, surely plaintiffs were entitled to believe that, should a change in the Code have occurred within the four-month period, the insured would have notified them of it. Bancroft testified that in selling the stock in both 1955 and 1957 he relied on the advice of the insured. But for the insured's advice and the failure of the I.R.S. to question that transaction, presumably the 1957 stock transfer would not have been effected and that loss would not have occurred. It is reasonable to conclude, we think, that as time passed without objection from I.R.S. or notice from the insured, Bancroft was justified in having confidence in the plan and in following the same procedure for sale of the additional stock in 1957.
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> (emphasis added, p. 55)

Therefore, the Court finds that the taxpayer is entitled to expect that the tax advisor will bring any material change in the law to the taxpayer's attention, when such change occurs subsequent to the rendering of the tax advisor's opinion and before the transaction is implemented.

The A.I.C.P.A. Statement on Responsibilities in Tax Practice addresses the issue of the responsibility of the accountant to advise his client of subsequent developments in the law which have an effect on advice previously rendered. The A.I.C.P.A. Statement provides that the CPA cannot be expected to be responsible for initiating communications with the client with regard to developments in the law which have affected prior advice except when the CPA is involved in assisting his client in implementing procedures or plans which are associated with that advice. This is of course in the absence of any specific agreement between the accountant and the client with regard to the accountant advising the client of any relevant changes in the law. The A.I.C.P.A. Characterizes the communication of significant developments which affect previous advice as being an extraordinary service and not one which normally arises out of the accountant/client relationship.

It was also argued in the Bancroft case, that the accountant was practicing law when he gave an opinion on the tax consequences of the transaction. This argument was raised by the accountants' lawyers who maintained that the plaintiff was not entitled to rely upon the accountant's opinion because the plaintiff knew that the accountant was not permitted to practice law.

In rejecting this argument, the Court took judicial notice of the fact that CPA's routinely render opinions and advise their clients on matters of federal and state income tax liability. The Court also heard evidence that a problem involving both accounting and taxation aspects was within the province of a CPA. The Court held that the accountant's opinion was one of a mixed legal and accounting nature and that the accountant was not practicing law.

The issue raised in the Bancroft case, i.e., whether an accountant who renders an opinion on the tax consequences of a transaction is practicing law, is one which should be considered by any tax specialist who is not a lawyer. The Legal Profession Act, R.S.A. 1980, prohibits any person from practicing or acting as a barrister or a solicitor unless they are an active member of the Law Society of Alberta. Any person who contravenes that provision of the Act is guilty of an offence under the Act. However, an accountant might also be liable to his client in civil proceedings if he renders an opinion interpreting the effect of a statute. The client may well allege that the accountant was negligent in giving advice which he was not qualified or entitled to give pursuant to the provisions of the Legal Professions Act and that the accountant ought to have directed his client to a tax lawyer if legal advice or a legal opinion was required. I recognize that there tends to be a blurring of the line that separates the tax accountant's practice from the tax lawyer's practice and that the public may be well served by obtaining an opinion interpreting the effect of the Income Tax Act from a tax accountant. However if accountants choose to give legal advice, they should consider the civil liabilities which they may be exposing themselves to.

The 1984 decision of the Supreme Court of Iowa in Martinson Manufacturing Company v. Seery, is probably the most interesting of the U. S. decisions from a tax practitioner's point of view. The case deals with the liability of a tax advisor for a tax plan which did not succeed.

The following is a brief summary of rather complicated facts. The defendants were a firm of attorneys who advised the plaintiff Martinson with regard to a plan to merge the plaintiff with another corporation by the name of Barnum Industries. The merger was proposed in order to permit Martinson to acquire the losses of Barnum, which was in financial difficulty. In due course Martinson purchased the Barnum stock and the two companies were merged. Subsequently Martinson's CPA's took the position that Barnum's losses were not available to Martinson. It would appear that the defendant lawyers acquiesced in this interpretation.

Whether or not Barnum's net operating losses were available to Martinson turned upon the interpretation of a provision of the Internal Revenue Code, section 334(b)(2). The correct interpretation of that section was the central issue in this case. Both parties called as witnesses well qualified tax experts who had very divergent views on the proper interpretation of the section. Significantly, there was no decided authority on point which was of any assistance to the Court in determining which interpretation was correct.

After hearing all of the expert evidence, the Court concluded that the interpretation of section 334(b)(2) was a question on which reasonable doubt could be entertained by well informed lawyers, and that accordingly the defendants were not negligent. In coming to this conclusion, the Court noted that in professional malpractice cases “the law does not impose an implied guarantee of results”. The Court went on to apply the following standard of care:

> If an attorney acts in good faith and in an honest belief that his acts and advice are well founded and in the best interest of his client, he is not liable for a mere error of judgment. A fortiori, an attorney is not liable for an error in judgment on points of new occurrence or of nice or doubtful construction, or for a mistaken opinion on a point of law that has not been settled by a court of last resort and on which reasonable doubt may well be entertained by informed lawyers.
>
> (p. 775)

I would suggest that this test is not strict enough. While it is true that a tax advisor is not necessarily liable as a result of an error in judgment, it does not seem appropriate to excuse a professional's error solely on the grounds that the professional acted in good faith and with an honest belief that the advice was well-founded and in the best interests of the client. However, while the Iowa Supreme Court may not have imposed as high a standard of care as it ought to have, the case is illustrative of the difficulties that can arise when tax advice is given on the basis of a statutory provision which has not been previously interpreted and about which competent tax experts have differing opinions.

In a recent Alberta case, Brown et al v. Shortreed et al the Alberta Court of Queen's Bench considered the liability of lawyers and accountants to a third party as a result of an alleged failure to provide proper tax advice. The facts of this case were that the Plaintiff Brown was the President of Hook Outdoor Advertising Limited ("Hook"). He had a shareholding in Hook and on his retirement a section 85 rollover was structured in order to allow Brown's holding company to acquire the shares. The evidence was clear that the defendant lawyers were engaged by Hook and not by Brown or his holding company. The lawyers took instructions from Hook and were paid by Hook. The lawyers prepared drafts of a rollover agreement and a share purchase agreement and met with Hook's accountants in order to review this matter. Brown admitted that he did not look to the defendant lawyers for tax advice and that he did not have any discussions with them about tax implications or tax matters. Brown also admitted that he was told by the lawyers to get his own legal and accounting advice and that a particular lawyer and a particular accountant were recommended to him. It was Brown's evidence that he looked to the defendant accountants for tax advice and that he was told by them that he would not have a tax liability until he withdrew money from his holding company.

The plaintiff suffered an unforeseen tax liability as a result of the transactions. While proceedings were commenced against both the accountants and the lawyers, the plaintiff discontinued the action against the accountants during the trial. The report of the case does not indicate the basis for the discontinuance and in particular whether a settlement was reached at that time.

The trial of the claim against the lawyers proceeded. The plaintiff argued that the lawyers owed a duty of care to him since they drew the agreements and generally authored the transaction. In determining whether the lawyers had a duty to the plaintiff, who was not their client, the Alberta Court of Queen's Bench applied the following tests:

> Did the lawyers place themselves in the position that they dealt with the plaintiffs' interests when the lawyers knew or ought to have known that the plaintiffs were relying on them to protect those interests thereby incurring a duty of care towards the plaintiffs in accordance with the well-known principles of Hedley Byrne & Co. v. Heller & Partners Ltd.…and Haig v. Bamford.…
>
> The rule with its two criteria is stated by Lord Reid: the professional man must know that the other is relying on his skill and the other must in fact rely on it.
>
> (p. 91)

The Court held that the lawyers were not responsible for errors arising out of the lack of proper tax advice since the plaintiff understood that both he and the lawyers were relying on the accountants with regard to taxation matters. Therefore while there does appear to have been a failure to recognize the tax consequences of the transaction as it was structured, no liability was attributed to the lawyers because there was no reliance upon the lawyers for tax advice. This case underscores the importance of clearly defining the terms of your engagement, particularly when other professional advisors are involved.

The Limitation Defence

One of the issues which may arise in cases involving the liability of tax advisors is that of the applicable limitation period. There have been some recent developments in the Canadian law pertaining to the interpretation of limitation periods which have the effect of extending the period of time within which an action may be brought.

In Canada and in Alberta in particular, the limitation period for the bringing of an action against a tax specialist is generally six years "after the cause of action arose". The question which the Courts have long wrestled with is: When does the cause of action arise?

In an action for breach of contract, the cause of action arises when the breach occurs, regardless of when the damage occurs or is discovered. Thus, in an action against a tax advisor for breach of contract, the cause of action would in most cases arise when the tax advisor makes the error or mistake which gives rise to liability.

However as we have seen earlier, the Supreme Court has recently decided that there is concurrent liability in contract and tort with regard to the rendering of professional services. With regard to when the cause of action arises in tort, there have been two competing schools of thought. One body of opinion holds that the cause of action in a tort claim arises when the damage occurs, regardless of when the damage was discovered or discoverable by reasonable diligence. This view was expressed by the Alberta Court of Appeal in a 1984 case involving solicitor's negligence, Ruzicka v. Costigan. The Alberta Court of Appeal took the position that to hold otherwise would be to defeat the purposes of limitation statutes, which were established specifically to prohibit the commencement of actions after a long delay.

However two decisions from the Supreme Court of Canada have expressed a contrary view, which is to the effect that the cause of action arises when the Plaintiff discovers the damage or ought to have discovered the damage with reasonable diligence. This view was first articulated by the Supreme Court in a 1984 decision, City of Kamloops v. Neilson. The Supreme Court at that time expressed concern with the possibility of a cause of action expiring before the plaintiff is even aware of its existence.

This issue was considered in greater detail by the Supreme Court of Canada in the aforementioned case of Central Trust Co. v. Rafuse et al. In that case Justice Le Dain conducted a careful review of the earlier authorities and applied the “discoverability rule” to a matter of professional negligence, in the following terms:

> I am thus of the view that the judgment of the majority in Kamloops laid down a general rule that a cause of action arises for purposes of a limitation period when the material facts on which it is based have been discovered or ought to have been discovered by the plaintiff by the exercise of reasonable diligence…There is no principled reason, in my opinion, for distinguishing in this regard between an action for injury to property and an action for the recovery of purely financial loss caused by professional negligence…
>
> (p. 180)

Notwithstanding the decisions of the Supreme Court of Canada, it must be said that there remains some question as to the applicable law in Alberta in light of the decision of the Alberta Court of Appeal. Some commentators have indicated that the Alberta Court of Appeal's decision must be considered as having been overruled by the decisions of the Supreme Court of Canada. However we do not yet have a decision wherein the Supreme Court of Canada or the Alberta Court of Appeal have confronted the conflicting opinions which they have rendered. Until that happens, the law in Alberta will continue to be in some doubt. I think the better view and certainly a more cautious one is to consider that when acting as a tax specialist, you are exposed to claims being advanced against you within six years of the date upon which your client or former client discovers that it has suffered damages as a result of your alleged negligence.

The Liability of the “In House” Tax Advisor

The law with regard to the liability of solicitors and chartered accountants has developed in the context of private practitioners, rather than employees. Thus, this paper focuses on the liability of the tax specialist who is in private practice and not employed as an “in-house” advisor. However, while the liability of an employee may be subject to special considerations arising out of the law of master and servant, which is outside of the scope of this paper, the in-house tax specialist is in general terms subject to the same duties and responsibilities as the tax advisor in private practice.

An employer is usually vicariously liable for the tortious acts of his employees when such acts are committed within the scope of employment. As a corollary to this principle of vicarious liability, the law also provides that an employer is entitled to seek indemnity from the employee for the vicarious liability. In other words, if your employer is vicariously liable to a third party as a result of your negligence, your employer is obliged to discharge that liability but is entitled to be indemnified by you for whatever amount the employer has paid. This indemnity flows from the implied term of the employment contract that the employee will perform his duties with proper care and skill.

In 1976, the British Columbia Court of Appeal applied these principles of law in a case which should be of interest to any employee, Overmyer Company of Canada Limited v. Wallace Transfer Ltd. and Pringle (Third Party). The third party Pringle had been employed as the general manager of the defendant Wallace Transfer. He signed a lease for warehouse space and knew that the lease contained a requirement that 30 days' notice be given prior to termination of the tenancy. He also knew that his employer wanted to terminate the lease and it was his responsibility to give notice on the appropriate date. He failed to do so and therefore the owner of the warehouse sued the employer for one months' rent. The employer in turn sought indemnity from the employee for that amount.

In a split decision, the majority of the British Columbia Court of Appeal held that the failure by the employee to give notice at the proper time, which was a matter for which he was responsible, constituted negligence. The Court said:

> In failing to do what he was clearly required to do, he failed to exercise his managerial duties with reasonable care and skill and as a consequence he is liable for the loss suffered by his employer in having to pay the December rent for the leased premises….
>
> (p. 657)

The duties and responsibilities of the salaried legal advisor were discussed by Lord Denning in Alfred Crompton v. Customs and Excise Commissioners. Lord Denning indicated that the legal advisor who is an employee is subject to the same duties and responsibilities as the solicitor in private practice:

> (The salaried legal advisors) are, no doubt, servants or agents of the employer. For that reason the judge thought that they were in a different position from other legal advisers who are in private practice. I do not think this is correct. They are regarded by the law as in every respect in the same position as those who practice on their own account. The only difference is that they act for one client only, and not for several clients. They must uphold the same standards of honour and of etiquette. They are subject to the same duties to their client and to the court. They must respect the same confidences. They and their clients have the same privileges.
>
> (p. 376)

In summary, there is an implied term of any contract of employment that the employee will exercise reasonable care and skill in the performance of his work. The employee will be liable if the employer suffers a loss as a result of the employee's conduct which fails to meet the required standard of competence. Therefore, if you are an in-house tax advisor and your employer suffers a tax liability as a result of your incorrect advice, your employer may be entitled to seek recovery of that tax liability from you.

It is not common practice for employers to bring suits against their employees for breach of the duty of care that is impliedly part of an employment contract. If employees considered that they were subject to such claims, it would doubtless inhibit them in the performance of their duties, which is not in the employer's best interests. Of course employees are usually not insured and therefore any sizeable loss would not be recoverable. However, if you are a solicitor or a chartered accountant who is employed as a salaried advisor, I see no reason why, in the absence of any specific agreement to the contrary, an employer should not be entitled to expect the same duty of care from you that it would be entitled to expect from solicitors and chartered accountants in private practice.
