

# INSURANCE ISSUES: *Risk Management*

A publication of the Law Society of British Columbia



Lawyers  
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## Income tax: it's a risky business

PRACTISING TAX LAW must sometimes feel like walking a tightrope without a net. One small misstep can have drastic consequences. And the world of tax law is in perpetual motion. A good tax plan today might be a bad plan tomorrow. Amendments to the *Income Tax Act*, changes in Canada Revenue Agency policy or new developments in tax jurisprudence can have totally unexpected ramifications. And even if you have a more general corporate or commercial practice, you are still at risk.

Each year, the Lawyers Insurance Fund deals with 20 to 25 tax-related claims. While this number may seem relatively small, the potential losses are not. In fact, they often exceed the limits of the compulsory policy.

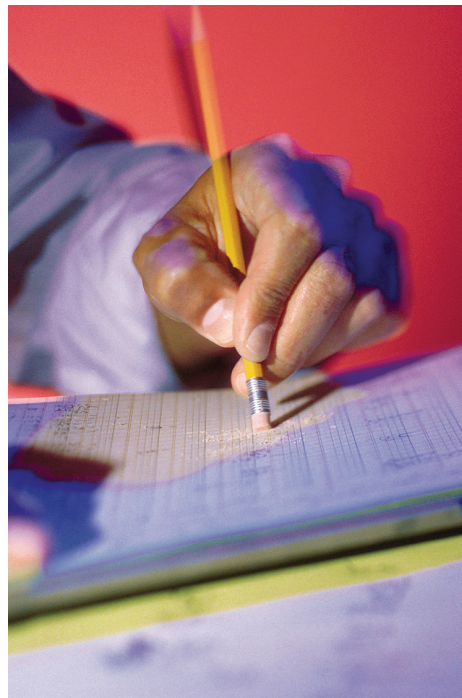
In this *Insurance Issues*, we identify some tax risks to practitioners and, drawing on our experience and that of lawyers who have reported tax matters to us, offer tips to help you recognize and manage those risks.

### Take the guesswork out

- *"Stay within your comfort [competency] zone."* – a lawyer who failed to appreciate that a tax free share transfer from father to son's company required transferring the shares first to the son personally.
- *"Consult specialists where appropriate."* – a lawyer caught by an estate freeze

that unintentionally triggered income allocation back to his client.

- *"Read and re-read the fine print in the Income Tax Act and other legislation."* – suggested by a number of lawyers with



tax as their preferred area of practice.

- *"This problem was caused by a little known policy change by the CRA on how to interpret a very old section."* – a lawyer who provided estate planning advice

on setting up trusts that contravened the *Income Tax Act*. Three capital gains exemptions were lost. Not surprisingly, she now suggests *"Continuing legal education."*

- *"Do a careful review of advice given by another lawyer in the firm."* – a lawyer who relied to his detriment on a colleague's advice.

Each year, three or four lawyers report that they have discovered their tax advice was just plain wrong. For example:

In dealing with a capital dividend election on behalf of a corporate client, a lawyer mistakenly believed that the dividend could be paid out at any time. In fact, the dividend could only be paid after the client's fiscal year end. Adverse tax consequences result.

Nothing good comes of dabbling. Be realistic about what you know and, if you are not certain, do not guess. And if you are comfortable acting, research any area you do not know cold or get the advice that you need. Even if tax is your preferred area of practice, you are at risk. Read legislation very carefully. Keep current in the law. Complex tax transactions may also involve several lawyers working on the matter, an issue if you rely on a colleague's erroneous interpretation of the *Income Tax Act*.

## Think through all the issues

- *"The rules are so dense. Be very, very careful to review the anti-avoidance rules in every re-organization, even when there is no apparent application."* – a lawyer who prepared a trust structure without appreciating that unrelated trusteeships triggered capital gains.
- *"Just more review."* – several lawyers caught short not carefully considering how the law would apply in a particular situation.

A significant risk relates to lawyers simply not thinking through all the legal issues, or the strategy needed to achieve the desired tax result. For example:

Lawyer acted for a client in the setup of an immigrant trust. His opinion on the appropriate termination date for the trust was not well analyzed. CRA is now assessing additional tax on the basis that the trust was not terminated in time.

Carefully consider all the angles and possible issues (particularly challenging in the tax arena).

## Beware the lurking tax issue

- *"Tax implications are not always predictable, when the services rendered are not tax-driven."* – a lawyer who was taken by surprise when a tax issue arose in a property transfer.
- *"Keep a detailed paper trail of your advice to clients that you are not providing tax advice, if that is the case, and urge them to speak to their accountant. Confirm your advice in writing."* – a lawyer who acted for a shareholder who, after realizing that her transfer of shares in a settlement triggered a capital gain, claimed that the lawyer had assured her that there would be no tax consequences.

Many transactions have unintended and undesirable tax consequences that could be avoided if a lawyer is cognizant of the potential tax implications. An example:

Lawyer acted for the vendor selling shares in a company to another shareholder. When the deal was revised to sell the shares to

the company, rather than the shareholder, the lawyer did not recommend tax advice or raise the possibility of tax implications. Unwelcome tax consequences resulted.

Tax is pervasive. Recognize that there will be tax consequences arising out of many corporate/commercial transactions, or situations in which property or funds change hands.

Alert your client to the possibility of tax consequences and confirm that you are not giving tax advice. Make sure this limitation is clearly reflected in your written retainer, and ask your client to sign to acknowledge their understanding. Such a document in your file will help us halt claims in their tracks. And since timing can be, and often is, *everything* from a tax perspective, caution your client about the limits of your retainer at an early stage.

## Pay particular attention to residency

- *"Too often, failing to nail down residency is the one flaw in an otherwise sound transaction."* – a LIF staff lawyer.

Residency is a wild card in the tax scenario, giving rise to two mistakes that we see with some regularity.

In the first, lawyers miss the requirement to withhold tax when dealing with non-resident clients or with clients making payments to non-residents:

In acting for claimant, lawyer failed to advise non-resident partners to seek waivers from CRA for business income to avoid the imposition of withholding tax. CRA has now assessed and will charge interest.

These claims can also arise when tenants pay rent to non-resident landlords and when purchasers pay sale proceeds for property or shares to non-resident sellers.

In the second scenario, lawyers fail to consider the *effect* of residency in the transaction:

Lawyer advising clients on section 85 roll-over under the *Income Tax Act* did not know that certain of the clients were US citizens. She failed to explain the consequences of the reorganization for non-residents, and

the family incurred US tax, interest and penalties.

Both types of mistakes are avoidable if lawyers flag residency as an issue; always find out if a non-resident is involved in a particular transaction or tax plan. And remember that tax consequences may be triggered by the residency status of a wide range of individuals and entities, including directors, recipients of dividend payments and vendors of shares.

## Clarify responsibilities between lawyer and accountant

- *"Clearly delineate responsibilities."* – a lawyer targeted after the client's accountant missed a step.
- *"It is important that lawyers make it clear to clients that, when a plan is conceived by the accountant or tax advisor, such accountant or advisor is responsible for its conception. It is also important that the tax advisor review draft documents before finalization."* – another lawyer, also targeted.
- *"Maintain notes as to the work/analysis to be done by the accountant (as I did), and confirm it in writing (as I should have done to better protect myself)."* – a lawyer reporting because the documentation relating to a matter did not include a necessary capital gain adjustment.

The need for both legal and accounting advice in dealing with a tax matter is another source of risk for lawyers. When the scheme goes sideways, clients usually throw both of their professional advisors into the mix and let them sort out who is at fault.

Sometimes, a lawyer is simply "papering" a tax-driven scheme conceived of by an accountant:

In acting for claimant in a section 85 roll-over, lawyer failed to transfer all of the common shares of a company. Lawyer maintains he is simply following the instructions of the company accountant.

Other times, the lawyer's role is even more limited:

Lawyer witnessed client's signature on documents relating to tax planning vehicle conceived of by accountant that was ultimately not accepted by CRA. Client may blame lawyer.

And still other times, it is the accountant's role that is more limited:

Lawyer represented client in tax appeal and signed a consent to judgment after forwarding it to the client's accountant for review. The judgment was missing an adjustment to a particular capital gain resulting in a potential tax liability to the client.

Lawyer prepared non-resident trusts for claimants, but the proper non-resident filings were not made with CRA and late filing penalties may now be imposed. Lawyer assumed accountant responsible for the filings.

In these reports, despite the accountant's involvement, the client asserted a duty on

the part of the lawyer to protect him or her.

Help us defend you. Define responsibilities, and put them in writing. Set out clearly in your retainer letter what each professional is doing, and confirm your understanding with the accountant. At a bare minimum, keep notes of advice to your client. And if you want to take on a function that falls more to an accountant, appreciate that your lack of familiarity with the process may create a problem. Better to leave it where it belongs.

## Use checklists and BF systems

- *"Use the available systems."* – a lawyer who didn't.
- *"If two or more lawyers are working on one file, every lawyer on the file should be required to record the doomsday (limitation) dates, otherwise one lawyer might assume the other lawyer has attended to the matter."* – a tax lawyer.
- *"Deal with problem files. Do not procrastinate – ask for help if you need it."* –

another tax lawyer.

As with every area of practice, sometimes the ball just gets dropped. The lawyer might forget to do something, or do it too late:

In the course of executing a section 85 roll-over, the lawyer forgot to issue shares in the transferee corporation to the taxpayer in consideration for the taxpayer's transfer of property. As a result, a tax deferral may be lost.

In acting for a taxpayer, the lawyer failed to provide information requested by CRA in a timely manner. CRA denied the tax relief being sought, allegedly based in part on the lawyer's delay.

And sometimes "too late" means missing a deadline, most frequently the 90-day limitation period for filing a notice of objection, limitations for tax appeals (including those set by court order) and limitations for claiming scientific research credits. How can you keep all those balls airborne?

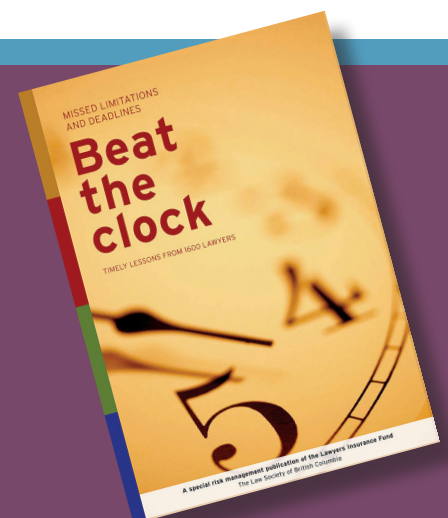
## If you discover a mistake, report it immediately

You are contractually and ethically obliged to report immediately to the Lawyers Insurance Fund if you discover a mistake, or if someone says you have made one.

Early reporting is particularly critical in tax matters, because some errors may be fixable, avoiding a much larger loss and often helping to preserve your relationship with your client. We frequently retain counsel to seek rectification, bring a specific motion in a tax appeal, or assist a lawyer in communicating with CRA. We take a variety of factors into account when deciding if a repair is a cost-effective approach, such as whether CRA has assessed the taxpayer and, if not, how likely it will, the amount at risk, and how difficult or costly the repair might be.

If we miss a repair opportunity because you report late (or not at all), you risk losing your insurance coverage. That risk increases if you actually attempt a repair yourself — for instance, backdating a document in an attempt to rectify a matter. Such a seemingly straightforward and simple step may not bring about the result you thought was guaranteed.

Even if we cannot make the problem go away, we offer a second set of eyes to help determine the extent, or even existence, of a tax problem. By putting the issue into context and an objective legal framework, we also bring a level of reassurance to lawyers facing a potential claim.



For a comprehensive list of requirements for effective systems to prevent missing deadlines, see *Beat the Clock – Timely Lessons from 1,600 Lawyers*. Covering over 70 risk management tips, this guide was sent to every insured lawyer in BC in 2007. It can be downloaded from the Lawyers Insurance Fund section of the Law Society website (go to Risk Management).



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Use firm-wide systems for limitations and deadlines, and checklists and personal systems to ensure you take all necessary steps in a timely manner (see *Beat the Clock* in the box on page 3).

Simple clerical mistakes in drafting documents also lead to reports:

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Lawyer acting for company inadvertently assigned shares with the wrong par value, which led to a deemed dividend far in excess of what was intended.

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Avoid these errors by reminding yourself, and your staff, to take a thorough second — or third — read-through of any document before it is finalized.

Appreciate that work and personal circumstances may make you more susceptible to oversights. Don't procrastinate, and seek help if you need it. And if you cannot take care of the matter because of work overload, personal stress or any other reason, transfer the file to someone who can.

### Communicate with your client

- “*This was a result of poor communication with my client*” – a lawyer who missed the deadline for appealing an assessment by CRA.

Make assumptions about your client's circumstances, interests or understanding at your peril. Some examples:

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Client instructed lawyer to hold off on filing a notice of objection to a CRA audit, but the lawyer failed to advise the client of the implications of delay. CRA refused an extension.

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Lawyer successfully negotiated a significant reduction of client's reassessed income tax. Given the excellent result, the lawyer didn't ask if the client wished to appeal those amounts still left in income. After the deadline passed, client advised that he expected an appeal.

Spend the time you need with your client gathering information and explaining your advice. Do not assume a higher level of legal knowledge simply because a client is more sophisticated or business-savvy. And remember always to seek informed instructions from your client. Not only do you owe this duty to your client, but by doing so, you pass the risk and responsibility of a wrong decision back to the client, where it belongs.

### A final note of caution: Buy excess insurance if you are at risk

Although the \$1 million policy limit offers generous financial protection for the majority of lawyers, it may not be enough to protect you if you give negligent tax advice. Excess insurance, available on the commercial market, extends the policy limit. Buy it if you are at risk.



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