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Legal professional privilege and accountants: *How confidential are your 'confidential' communications?*

Effective taxation advice requires a mix of legal and accounting skills. As such, both accountants and lawyers are consulted on taxation matters.

Taxpayers who consult taxation lawyers are afforded the protection of legal professional privilege (**LPP**), which prohibits from disclosure certain confidential communications between a taxpayer and their lawyer. However, taxpayers who consult accountants are not afforded the same protection and there is an inherent risk that their communications may require disclosure in certain circumstances.

What is legal professional privilege and why is it relevant?

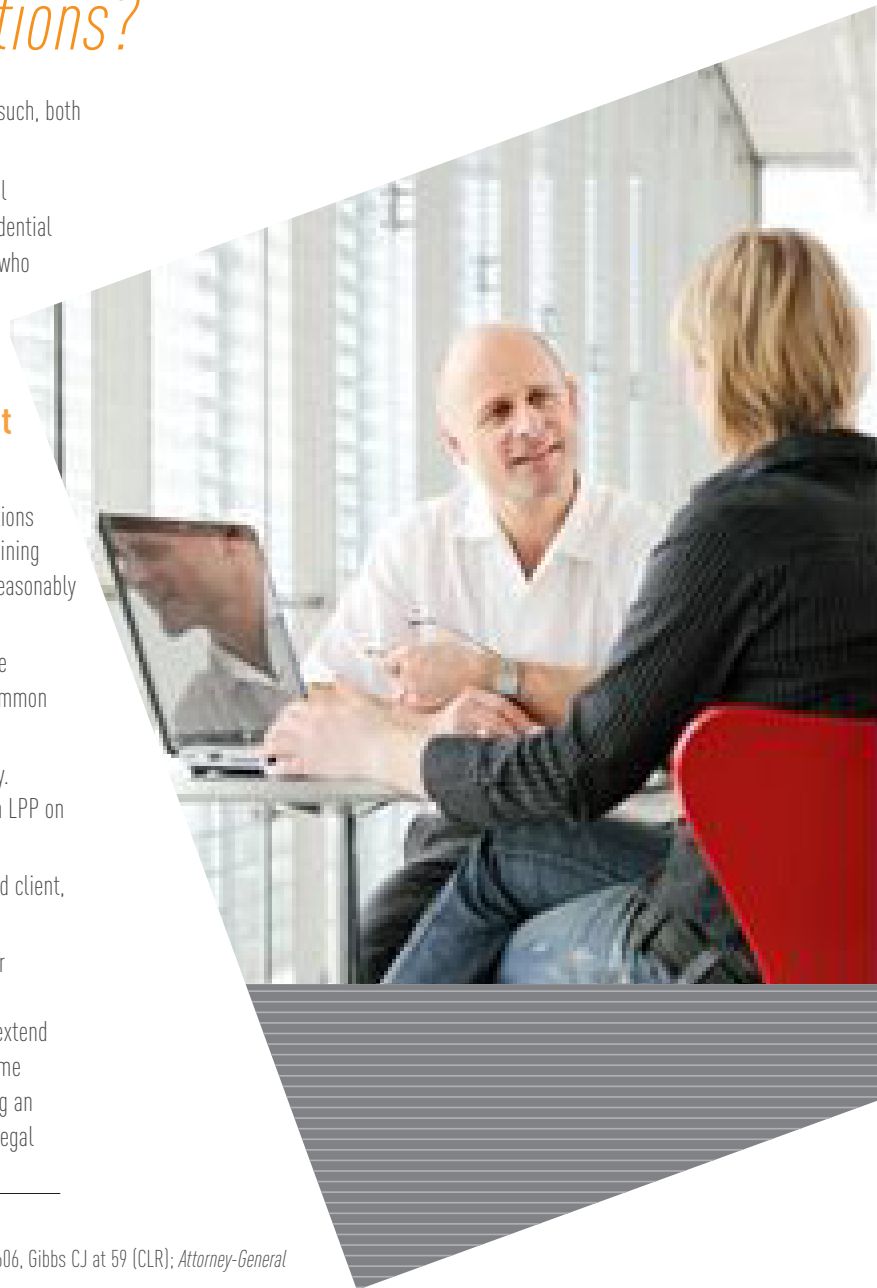
LPP protects from compulsory disclosure certain confidential communications between a legal adviser and client for the dominant purpose of either obtaining legal advice from a legal practitioner or for the use in actual, pending or reasonably anticipated legal proceedings.

The right to LPP exists under the *Evidence Act 2008* (Vic) with respect to the adduction of evidence in judicial or quasi-judicial proceedings,¹ and at common law.

LPP is not an automatic right but rather, must be claimed in order to apply. Although the privilege belongs to the client, the lawyer will normally claim LPP on behalf of their client.

To establish LPP over communications passing between a legal adviser and client, three criteria must be satisfied.

First, the communication must pass between the client and a legal adviser acting in their capacity as a legal adviser.² In other words, there must be a professional relationship of lawyer and client.³ Accordingly, LPP does not extend to communications between accountants and their clients. However, in some circumstances LPP may extend to a document prepared by a third party (eg an accountant) on the authority of the principal for the purpose of obtaining legal



¹ *Evidence Act 2008* (Vic), ss 118-119

² *Baker v Campbell* (1983) 153 CLR 52; 57 ALJR 749; 14 ATR 713; 49 ALR 385; 83 ATC 4,606, Gibbs CJ at 59 (CLR); *Attorney-General (NT) v Kearney* (1985) 158 CLR 500; 59 ALJR 740; 61 ALR 55

³ *Attorney-General (NT) v Kearney* (1985) 158 CLR 500; 59 ALJR 740; 61 ALR 55

advice, so long as the third party is not an employee of the principal⁴ (discussed below).

Secondly, the communications must be made for the dominant purpose of enabling the client to obtain the legal advice, or for the purpose of actual or contemplated litigation.⁵ In meeting this requirement it is accepted that a document may come into existence for a number of reasons, but so long as the main purpose of the document is legal advice or related to litigation, the document will be privileged.

Thirdly, the communication must be confidential.⁶ A communication that lacks confidentiality will not be privileged even though it is between a legal adviser and a client. In this context, it is important to err on the side of caution in passing communications on to third parties. As is often the case, such behaviour may be perceived as an indication that a communication was not intended to be confidential, and therefore not privileged.⁷

Why is LPP important in a tax context?

Taxation law is increasingly complex and taxpayers almost always require the assistance of legal advisers or accountants to manage their taxation affairs.

The importance of LPP in a taxation context is highlighted by the nature of the relationship between adviser and client. Advisers are required to abide by legal requirements while aiming to minimise their client's taxation liability. In balancing these obligations, advisers will often encourage their client to comply with all legal requirements but will interpret such requirements aggressively in favour of their client wherever possible. Material facts will often affect the ease with which a taxpayer can meet their compliance requirements and can assist the taxpayer in avoiding any future controversy with the Australian Taxation Office (ATO) and other statutory authorities. As such, the emphasis in seeking tax advice is on full and frank disclosure. Taxation advice is most effective when the adviser is presented with all material facts pertaining to their client's state of affairs. However, some clients are selective in the facts they present to their adviser through fear

of negative repercussions. This behaviour can lead to incorrect assumptions on behalf of the adviser, ineffective and inaccurate advice and in the worst cases, breaches of legislative requirements.

The fear of many taxpayers is the extensive information gathering powers possessed by the ATO and other statutory authorities such as the Australian Customs and Border Protection Service and the Australian Crime Commission, which enable them to gain access to the information of taxpayers.

Under section 262A of the *Income Tax Assessment Act 1936* (Cth) (ITAA 1936), a person carrying on business must keep records that record and explain all transactions and other acts engaged in by the person that are relevant for the purposes of the Act. In this regard, sections 263 and 264 govern the Commissioner's access powers to such records.

Section 263 provides that the Commissioner or any officer authorised by him in that behalf shall at all times have full and free access to all buildings, places, books, documents and other papers for any of the purposes of this Act, and for that purpose may make extracts from or copies of any such books, documents or papers.

Section 264 goes further and provides that the Commissioner may by notice in writing, require any person, whether a taxpayer or not, including any officer employed in or connection with any Department of Government or by any public authority to furnish him with such information as he may require; and to attend and give evidence before him or before any officer authorised by him in that behalf concerning his or any other person's income or assessment and may require him to produce all books, documents or other papers whatever in his custody or under his control relating thereto.

Sections 263 and 264 are independent provisions and there is no requirement that the availability of one be exhausted before recourse to the other. Consequently, to obtain documents, the Commissioner can either use his power under section 263 to enter premises to make extracts from or copies of books and records, or use his power under section 264 to issue and serve a notice for the production of documents.

Despite the wide ambit of the provisions, the courts have held that sections 263 and 264 should not be read as referring to documents to which LPP attaches. In *FCT v Citibank* (1989) 85 ALR 588, the Full Federal Court held that LPP restricts the operation of section 263. Similarly, in *Perron Investments Pty Ltd v DFCT* (1989) 90 ALR 1, the Full Court of the Federal Court held that section 264 is subject to LPP.

LPP provides wide protection from the extensive information gathering powers of the ATO and will operate to prevent the ATO from obtaining documents made pursuant to obtaining legal advice from a legal adviser.

The importance of LPP in a taxation context is further complicated by the problems faced by taxpayers in terms of choosing whether to consult a legal adviser or an accountant to manage their tax affairs. Taxpayers who seek advice from a legal adviser will be afforded the protection of LPP. Accordingly, any communication of a confidential nature and any documents drawn up as a result of seeking such advice or in preparation for litigation will be privileged. On the other hand, tax advice received from an accountant will be afforded no such privilege and there may be circumstances in which such confidential communications or documents need to be disclosed.

What protection does exist?

There are two main sources of protection for communications between an accountant and their client: the ATO's administrative accountants' concession and limited aspects of the formulation of LPP that protect certain communications with third parties, such as accountants.

The ATO has provided an administrative concession known as the 'accountant's concession', which places the accountant client relationship in a similar position to that of the lawyer client relationship.

The accountants' concession allows a range of documents to remain confidential, despite not being subject to LPP. It should be noted however that the accountants' concession is merely an administrative concession. As such, at best, it raises only a legitimate expectation that the guidelines

⁴ *Pratt Holdings Pty Ltd v FCT* (2004) 56 ATR 128

⁵ *Esso Australia Resources Ltd v Commissioner of Taxation* (1999) 201 CLR 49; 74 ALJR 339; 43 ATR 506; 168 ALR 123; 2000 ATC 4,042; [1999] HCA 67

⁶ *Baker v Campbell* (1983) 153 CLR 52; 57 ALJR 749; 14 ATR 713; 49 ALR 385; 83 ATC 4,606, Gibbs CJ at 67-68 (CLR); *R v Brahan* [1976] VR 547, Lush J at 549

⁷ *R v Brahan* [1976] VR 547, Lush J at 549

will be followed. LPP, on the other hand, offers far greater protection in that it is a common law right, enforceable at law.

The accountants' concession is outlined in Chapter 7 of the ATO's Access and Information Gathering Manual, which contains guidelines on the exercise of the ATO's powers with respect to accessing documents prepared by external professional accounting advisers.

The guidelines apply to requests for access to documents made for any purposes of the ITAA 1936 or *Income Tax Assessment Act 1997* (Cth) (ITAA 1997) or any other Act administered by the Commissioner. Importantly, the guidelines apply in relation to requests for information (sections 263 and 264).

The guidelines classify documents into three categories:

- source documents;
- restricted source documents; and
- non source records.⁸

'Source documents' include papers prepared in connection with the recording of a transaction or arrangement. As such, they are an integral part of the process leading up to a transaction or arrangement, or to the recording of a transaction or an arrangement in the formal books or records of the company. ATO officers have full access to source documents, other than those referred to in the guidelines as restricted source documents, during the course of an audit of a taxpayer's taxation affairs.⁹

'Restricted source' documents include advisings and advice papers prepared by an external accountant solely for the purpose of advising on tax-related matters. They often explain the background, process and completion of transactions or arrangements and the thought process leading to their implementation.¹⁰

'Non source records' are records that are neither source nor restricted source documents, such as advisings prepared after a transaction has been completed and not affecting the recording of the transaction, or relating solely to unimplemented transactions, or working papers in a current audit file prepared by an external accountant in the course of a statutory or prudential audit or due diligence report.¹¹

Access to 'restricted source documents' and 'non source records' of external accountants by the Australian Taxation Office will not be granted other than in exceptional circumstances, such as when the ATO 'is unable to ascertain from the documents which have been provided, the facts necessary to determine the taxation consequences of the particular transactions or arrangements'¹² or where there are 'reasonable grounds to believe fraud or evasion has taken place'.¹³ While the fraud/evasion exception exists to defeat a claim of LPP at common law, the power of the ATO to inspect documents to ascertain taxation consequences of transactions is well beyond the exceptions to LPP and leaves the accountants' concession open to what would assumedly be an easy exception to apply.

The limitations of the concession are further highlighted by the fact that it will only apply in circumstances where documents have been prepared by an external professional accounting adviser who is independent of the taxpayer and for the sole purpose of providing advice. As such, the concession does not apply to communications with internal tax advisers¹⁴ and will not apply if documents are created for supplementary reasons, such as annual reporting, bookkeeping and the like.

It is arguable that some aspects of LPP may apply to protect some communications between accountants and their clients.

Confidential communications between third parties, such as accountants and their client or legal adviser may attract LPP. There have been

various formulations of the principles applied to communications with third parties. It is generally accepted that LPP will apply in the following three situations:

- where the third party is the agent of the client and the communication is made for the sole purpose of either anticipated litigation or obtaining legal advice;¹⁵
- where the third party is not an agent of the legal adviser or client but the communication is made to the legal adviser at the request of the lawyer or client for the sole purpose of current or anticipated litigation;¹⁶ and
- where the third party is not an agent of the legal adviser or client but the communication is made to the client either at the request of the legal adviser or client for the sole purpose of current or anticipated litigation.¹⁷

Communications falling within the first category are communications between legal adviser and client and are protected for that reason. In these circumstances, an accountant is typically engaged to act as agent for their client and communicates with their client's legal adviser for the purposes of providing taxation advice or for assistance in legal proceedings.

Communications falling within the latter two categories represent communications for the purposes of contemplated or actual litigation. In these circumstances, a legal adviser is instructed to communicate with their client's accountant and likewise the client's accountant is instructed to communicate with their client for the purposes of current or anticipated litigation.

Although these circumstances indicate that principle and authority requires a sharp distinction between third parties and agents, it is difficult to envisage circumstances in which the third party will not be regarded as agent of the client to obtain legal advice.

⁸ ATO, Access and Information Gathering Manual (2005) Ch 7, <http://www.ato.gov.au/corporate/content.asp?doc=/content/51035.htm>, viewed on 16 April 2011 at 7.14

⁹ ATO, Guidelines to accessing professional accounting advisors' papers, <http://www.ato.gov.au/corporate/content.aspx?doc=/content/51665.htm>, viewed on 17 May 2011 at 2.1

¹⁰ ATO, Guidelines to accessing professional accounting advisors' papers, <http://www.ato.gov.au/corporate/content.aspx?doc=/content/51665.htm>, viewed on 17 May 2011 at 2.2

¹¹ ATO, Guidelines to accessing professional accounting advisors' papers, <http://www.ato.gov.au/corporate/content.aspx?doc=/content/51665.htm>, viewed on 17 May 2011 at 2.3

¹² ATO, Access and Information Gathering Manual (2005) Ch 7, <http://www.ato.gov.au/corporate/content.asp?doc=/content/51035.htm>, viewed on 16 April 2011 at 7.2.3

¹³ ATO, Access and Information Gathering Manual (2005) Ch 6, <http://www.ato.gov.au/corporate/content.asp?doc=/content/51035.htm>, viewed on 16 April 2011 at 6.2.30

¹⁴ ATO, Access and Information Gathering Manual (2005) Ch 7, <http://www.ato.gov.au/corporate/content.asp?doc=/content/51035.htm>, viewed on 16 April 2011 at 7.1.5

¹⁵ *Grant v Downs* (1976) 135 CLR 674; 51 ALJR 198; 11 ALR 577

¹⁶ *Macedonia Pty Ltd v Federal Commr of Taxation* (1987) 18 ATR 929; 87 ATC 4565 (SASC) White J at 931-932 (ATR)

¹⁷ *Trade Practices Commn v Sterling* (1979) 36 FLR 244 (Fed Ct), Lockhart J at 245-246

While this protection is useful in theory, it is often difficult to maintain in practice. Although a client may instruct their accountant to deal with their legal adviser on their behalf, there may be circumstances in which the client relays information to the legal adviser or accountant and waives privilege. Likewise, there may be similar circumstances where an agency relationship is abused or broken and communications extend beyond the relationship and lose their confidential status.

Recent tax controversies

Recent case law demonstrates that LPP may apply with respect to tax advice given by accountants, but only in limited circumstances.

The decision in *Pratt Holdings Pty Ltd v Commissioner of Taxation* [2004] FCAFC 122 (**Pratt**) demonstrates that common law LPP may extend to communications with third parties, provided that they are made for the dominant purpose of seeking legal advice where there is no actual or anticipated litigation.

The decision also establishes that where the dominant purpose for preparing a report from third parties (ie accountants) is to obtain legal advice about it, privilege will exist whether or not the report is commissioned by a client, its principal or otherwise.

Pratt was the ultimate parent company of the Pratt group of companies. In implementing a major balance sheet reconstruction and refinancing program, an issue arose concerning the taxation consequences of substantial losses that had been incurred by an entity in the Pratt group. The group's taxation manager sought advice from Arnold Bloch Leibler (**ABL**), who recommended that Pratt engage an independent accounting firm to obtain a valuation of assets to assist in determining the exact quantum of the loss.

Pratt engaged PriceWaterhouse Coopers (**PWC**) to undertake the work, including the preparation of a report. Pratt informed PWC that he intended to use the report for the purposes of obtaining legal advice from ABL. PWC subsequently provided the report to Pratt and Pratt forwarded the report to ABL.

At first instance, the Federal Court held that the report did not attract LPP, because the communication had been made with a third party (**PWC**) – and unless the third party is acting as agent for the client, such communications will not be privileged.

Pratt appealed to the Full Federal Court, who allowed the appeal. The Full Court determined that the important consideration was not the nature of an accountant's relationship with their client, but rather the function that the accountant performs for their client. The Full Court held that if the function of PWC was to enable Pratt to make a communication in order to obtain legal advice, then LPP should apply.

The decision in Pratt indicates that claims for privilege will only succeed when the required purpose – that is, to seek legal advice or for use in litigation – can be established. Accordingly, if an accountant is retained to provide advice to a client, that advice will not necessarily be privileged merely because the client forwards it on to their lawyers. To successfully claim LPP, it will be essential to demonstrate beyond reasonable doubt that such advice has been obtained for the dominant purpose of obtaining legal advice.

Decisions since Pratt have demonstrated that courts will exercise caution in determining whether a document has been prepared for the purpose of obtaining legal advice.

In *Quality Publications Australia Pty Ltd v FCT* [2009] FCA 1293 (**Quality Publications**), a taxpayer's claim that documents prepared by its accountants were privileged was rejected by the Federal Court on the basis that there was insufficient evidence to show that the documents had been prepared for the purposes of obtaining legal advice.

The taxpayer was subpoenaed and claimed LPP over 66 documents that had been prepared by its accountants. In making their claim, the taxpayer referred to the principles expounded by Pratt.

The Commissioner challenged the claims of privilege.

The Federal Court ultimately determined that the taxpayer had failed to produce evidence to establish that the documents had been prepared by their accountants for the purposes of giving or obtaining legal advice at the time of their production. The court noted that the taxpayer's legal advisers had had little involvement with the documents subject to the claim, and in some instances the documents predated the appointment of legal advisers. Accordingly, the taxpayer's claim for LPP could not be maintained.

The decision in Quality Publications illustrates the complications that some taxpayers may have if they rely wholeheartedly on the circumstances pertaining to the decision in Pratt. In order to strengthen a claim for privilege, it is perhaps more prudent to

engage legal advisers to deal directly with third parties, such as accountants, to obtain relevant documentation and reports. Had the taxpayer in Quality Publications done so, it would have been difficult for the court to conclude that such documents had not been obtained for the dominant purpose of obtaining legal advice.

Concluding remarks

LPP is an integral feature of the lawyer client relationship and provides a strong foundation for the provision of privileged information between a client and their legal advisor. In a tax context, both lawyers and accountants provide advice and act for their clients, but only the client lawyer relationship benefits from the protection afforded by LPP.

While recent case law has indicated that documents prepared by accountants may be afforded the protection of LPP in circumstances where they were produced to obtain legal advice, many taxpayers relying on this general assumption have faced problems in demonstrating that documents prepared by their accountant were directly relevant to and prepared for the dominant purpose of obtaining legal advice. Accordingly, the safer position to take from recent decisions is that legal advisers may seek the direct assistance of their client's accountant in preparing taxation advice.

Although the Commissioner for Taxation has provided the accountants' concession to protect from disclosure certain taxation documentation, this protection is administrative only and cannot be enforced at law.

One of the main problems emerging from the divergence of protection is the difficulty encountered in distinguishing between the nature of the accountant client relationship and the lawyer client relationship in the provision of taxation advice.

Many argue that accountants provide services to their clients that are not dissimilar to those provided by a legal adviser to their client, and as such, notes, opinions, memoranda and correspondence produced by accountants should be afforded a similar protection to LPP. In this context, it is stressed that clients should be able to engage in full and frank discussions with their accountant in the knowledge that their confidential communications will enjoy the protection of LPP.

In early 2008, the Australian Law Reform Commission (**ALRC**) released a report that recommended

extending client legal privilege to 'tax advice documents': that is, confidential documents created by independent professional accounting advisers for the dominant purpose of providing advice about the operation and effect of tax laws. The central idea behind the ALRC's recommendations was the need for a single federal statute addressing the application of privilege in federal investigations. To date, the recommendations in the report have not been adopted.¹⁸

In April of this year, Assistant Treasurer Bill Shorten released a discussion paper that investigated whether or not clients of accountants should be afforded privilege for taxation advice documents prepared for them, which currently have to be disclosed to the ATO. In anticipation of the paper's release, Mr Shorten said that, while the extension of privilege to tax advice documents of accountants 'is by no means a foregone conclusion, there are cogent reasons for a robust debate on this issue'.¹⁹ Mr Shorten acknowledged that the accounting profession would 'rightly point out the degree of candour and frankness in any tax advice given by accountants is tempered by the ability of investigatory agencies to access, in certain circumstances, the advice provided', and noted the limitations of the ATO's accountants' concession.²⁰ He further said that, given the substantive complex nature of advice provided by tax accountants to their clients, it is argued that the absence of privilege puts the profession at a competitive disadvantage. He did, however, note that lawyers might argue that lawyer client privilege is safeguarded by the additional duties incumbent on lawyers as officers of the court, and that the absence of such a duty among accountants would be futile to their claim.²¹

The paper proposes the introduction of a privilege for accountants and their clients, which would apply similarly in practice to LPP.²²

According to Mr Shorten, the discussion paper considers the previous recommendation by the ALRC of establishing tax advice privilege to protect against the coercive information gathering power of the Tax Commissioner in greater detail 'by exploring the implications for stakeholders if a privilege is established, and seeks stakeholder and community feedback'.

The closing date for submissions on the paper's proposals was 15 July, 2011.

Even if Australia does implement a tax advice privilege, it is unlikely that it would offer the same protection as LPP. New Zealand implemented a 'non disclosure' right in 2005, which aims to protect tax advice documents created by tax advisers for their clients. However, this non disclosure right is subject to a number of qualifications and very strict rules about its operation. For example, a claim of non disclosure can only be made where the Inland Revenue authority enacts its powers under the NZ equivalent to sections 263 and 264. Furthermore, only 'books' or 'documents', as defined by the legislation, will be accorded protection. There are also strict timelines in which claims for non disclosure can be made and claims must be in an approved form and contain specified information. Accordingly, this non disclosure right is not a right or a privilege per se, but rather a specific rule subject to the control and involvement of the Inland Revenue authority.

Based on the New Zealand experience, it is difficult to envisage a tax advice privilege that would offer the same protection as LPP. Any statutory derived privilege is likely to be subject to conditions and qualifications that inevitably narrow its application and reduce its ability to protect confidential communications.

If Australia were to implement a tax advice privilege, it would be imperative that it have wide application, reasonable timeframes for claiming the privilege, simple procedures for claiming the privilege and regulation by an independent body.

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¹⁸ Privilege in Perspective: Client Legal Privilege in Federal Investigations (ALRC Report 107), accessed at <http://www.alrc.gov.au/report-107> on 12 April 2011

¹⁹ Address to the Institute of Chartered Accountants 2011 National Tax Conference, Melbourne, accessed at <http://ministers.treasury.gov.au> on 12 April 2011

²⁰ Privilege in Perspective: Client Legal Privilege in Federal Investigations (ALRC Report 107), accessed at <http://www.alrc.gov.au/report-107> on 12 April 2011

²¹ Privilege in Perspective: Client Legal Privilege in Federal Investigations (ALRC Report 107), accessed at <http://www.alrc.gov.au/report-107> on 12 April 2011

²² Privilege in relation to tax advice, Discussion Paper 2011 accessed at <http://www.treasury.gov.au> on 31 May 2011