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Some Tax Consequences of Litigation

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16 February, 2021

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A. Introduction

- IHT and CGT generally concerned with gifts and other voluntary disposals
- However, litigation over trusts and estates can also trigger charges to tax in some circumstances
- When client involved in litigation, may need to advise on the tax consequences of a settlement, successful outcome at trial, or the claim failing

B. Overview

- We will look at tax issues in three common scenarios:
  - Settlement of a claim to establish an interest in a trust or estate
  - Proprietary estoppel
  - Setting aside gifts/trusts

C. Settling a claim

1. Example:

- A settlor (S) establishes a trust, whereby shares (worth £100,000) vests in "my good friend John" in 2015.
- S (who has since died) had two good friends called "John".
- The 1st John brings a claim for the construction of the trust, claiming he is the relevant "John", which is opposed by 2nd John.
- In 2020 they settle the claim and agree to split the shares 50/50.
- Shares worth £200,000 at date of the Settlement.

2. Tax analysis

- IHT? –commercial agreement so s. 10 IHTA should apply

- CGT is more problematic:
  - If 1st John entitled to the shares, then he disposes 50% of capital to 2nd John on settlement.
  - If 2nd John entitled to the shares, then he disposes 50% of capital to 1st John on settlement

- Without court order on construction, we don't know who – 1st John or 2nd John? – is making the disposal

3. *Zim Properties Ltd v Proctor* [1985] STC 90

- "… a right to bring an action to enforce a claim that was not frivolous or vexatious, which right could be turned to account by negotiating a compromise yielding a substantial capital …" counts as an "asset".

- When 1st John settles the claim, he makes a "disposal" of his claim against 2nd John (and vice versa)

4. Computing the gain

- In exchange for claim against 2nd John, 1st John acquires 50% value of the shares (£100,000)

- What is 1st John's acquisition cost?
  - Market value in 2015? But s. 17(1) TCGA does not apply
  - So acquisition cost is amount 1st John paid for claim, i.e. **nil**.
  - Means entire sum of £100,000 liable to CGT.

5. Extra statutory concession D33

- Avoid this outcome as 1st John benefits from Extra stat concession D33
- Treat 1st John *as if* he were disposing of part of the shares (not his claim)
- Then can apply market value rule:
  - He is deemed to receive 50% value of the Shares (£100,000)
  - He can deduct 50% of market value in 2015 (£50,000)
  - Chargeable gain: £50,000

D. Proprietary Estoppel

- What is it?

The ingredients necessary to raise an equity are (a) an assurance of sufficient clarity (b) reliance by the claimant on that assurance and (c) detriment to the claimant in consequence of his reasonable reliance; *Thorner v Major* at [29].

  - Frequently arises where promisor has died without giving effect to promise: e.g. *Thorner v Major*

  - But can involve claims during lifetime of promisor: e.g.*Gillett v Holt; Moore v Moore; Habberfield v Habberfield*

D. Proprietary Estoppel

- The court order giving effect to an equity can have IHT; CGT and income tax consequences

"The impact of IHT, capital gains tax ("CGT") and income tax all needed careful consideration, with the benefit of expert evidence, or at least submissions from counsel well versed in the relevant areas of tax law. Despite the vast amounts of money spent on this litigation, the judge was unfortunately left with next to no assistance on this important subject….In my view, this should be as unacceptable in a substantial proprietary estoppel case as it would be in a big money divorce case." (*Moore v Moore* per Henderson LJ [96]

D. Proprietary Estoppel

- Death of promisor where there is potential estoppel claim can also have tax implications
- Example 1:
  - Quentin dies leaving his estate to his daughter Rosie
  - Quentin's son, Simon, makes a successful claim in proprietary estoppel to a house in his estate, which represents 50% of estate's overall value.
  - Can Rosie argue that Simon's claim reduces the value of Quentin's estate for IHT? Does Simon benefit from the CGT uplift to Simon's death?

D. Proprietary Estoppel

- *IHT*
- What was remedy?
- If declaration that house belongs beneficially to S, was it part of Q's estate at all?
- Otherwise deductibility from Q's estate at death depends on whether equity is a "liability" for purposes of s.5(3) of the IHTA 1984.
- Section 5(5):- deductible if and to extent either (a) liability imposed by law or (b) for consideration in money or money's worth
- Was the creation of the equity itself a "transfer of value"?

D. Proprietary Estoppel

- *CGT*
- Does S benefit from uplift at death?
    - What was the remedy?
        - If declaration that asset held by Q and Q's estate on trust for S, then no.
        - If some other remedy, then yes.
- Is there a CGT disposal when asset transferred to S pursuant to court order?
    - Yes; unless giving effect to pre-existing trust right.

D. Proprietary Estoppel

- *Example 2*
- As above, but Q *does* leave S the promised land
  - Is Q's estate reduced by S's "equity"?
  - Is IHT analysis the same as Example 1?
  - In what respects is CGT analysis different from Example 1?
    - S is a legatee, so any transfer to him is no gain/no loss under section 62(4) of TCGA 1992.

E. Setting aside a gift or trust

- Where a settlor declares a trust or makes a gift as a result of mistake, fraud or undue influence, affected parties may be able to have transaction rescinded.

- Rescission of a gift or trust means treat it as having never happened.

- "… the transferor has an equitable right (ie mere equity) to recover the property by having the transfer set aside, and the court declares that from the outset the transferee has held the property to transferor's order …" (*Twinsectra Ltd v Yardley* [1999] Lloyds Rep 436, 462)

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Example

- X gifts a painting to Y in 2015 as a result of Y's undue influence.
- X dies in 2020 leaving entire estate to Z.
- Z brings a claim to set aside the 2015 gift to Y.

- If claim succeeds, then treat the 2015 gift as having never happened.
  - Y would have acquired painting on bare trust for X
  - X's estate includes the equitable interest in the painting
  - This interest passes to Z on X's death

Tax consequences

- IHT
  - X's estate included the interest in the painting – may need to file corrective accounts
  - Could result in additional IHT being paid by Z
- CGT
  - X's estate included the painting, so get the death-uplift
  - Z acquires painting at market value at death
  - If Z sells the painting, may be able to deduct legal costs - s. 38(1)(b) TCGA 1992: any expenditure "wholly and exclusively incurred by him in establishing, preserving or *defending* his title to, or to a right over, the asset" shall be deductible in computing the loss.

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Thank you, any questions?

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28 February 2019

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