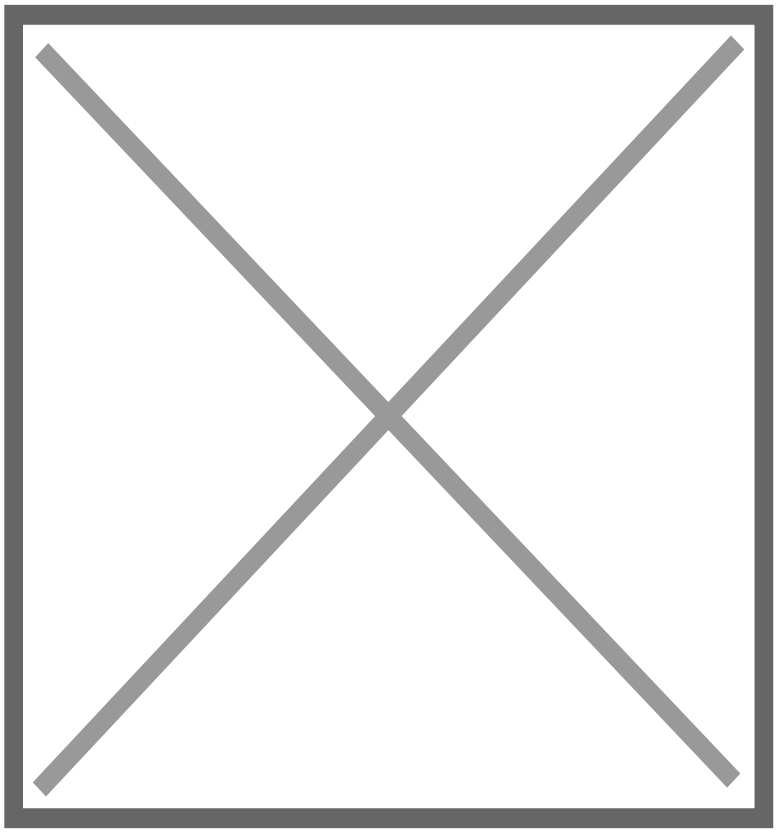
Losing the original

Inheritance tax and trusts



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Harriet Brown reviews the recent case of Chadda, which considered the interaction between land law and inheritance tax

Key Points

What is the issue?

The recent case of Chadda illustrates the importance of ensuring that jointly held property is held in the appropriate way for whatever inheritance tax planning is being considered, as well as the importance of keeping good records

What does it mean for me?

In order for a promise to pay arrangement (and indeed, a nil rate band trust) to function, it was necessary that the family home was held as tenants in common, not joint tenants

What can I take away?

It is essential to establish how the property is held. If it is held as joint tenants, the joint tenancy must be severed. In terms of dealing with HMRC, the safest approach to severance will be by notice. Such notice must be kept safely, because it may be required later

The recent case of *Chadda, Nash and Moroney v HMRC* [2014] UKFTT 1061 (TC) (Chadda) gives rise to a number of interesting points for tax advisers. The case deals with a relatively simple inheritance tax point, which is whether or not a nil rate band (NRB) discretionary trust had been successfully established. However, it also illustrates the importance of ensuring that jointly held property is held in the appropriate way for whatever inheritance tax planning is being considered. Another issue highlighted is the importance of keeping good records, especially in the context of inheritance tax planning, where planning can be put in place years before it comes to fruition.

Case background

Mr Chadda had acted as accountant to an elderly couple, the Tobins; and Mrs Moroney and Mrs Nash were two of the Tobins' children. Along with Mr Chadda, Mrs Moroney and Mrs Nash were the executors of Mrs Tobin's will. Mr Chadda had recommended that the Tobins should consider inheritance tax planning, so as to make use of both of their NRBs (see Box 1). (It should be noted that both the Tobins died before the introduction of transferable NRBs.) It was particularly important to the Tobins that they utilised both NRBs, because they were anxious to provide for a third daughter, Mary Tobin, who could not care for herself.

Box 1 – NRB Trusts: A Brief Introduction

NRB trusts have not been frequently used since the introduction of transferable NRBs on 7 October 2007.

A transferable NRB means that when one partner in a marriage or civil partnership dies, any unused NRB can be transferred to the surviving partner, allowing them to have an increased NRB for IHT purposes.

Before October 2007, it was common to achieve the same effect by executing wills that left the available NRB to a trust. When the first partner died, their NRB would be used up by the gift to the trust. Where the only asset sufficient to satisfy the gift to the NRB trust was the deceased's share in the family home, this would be achieved by means of a 'promise to pay' arrangement.

The planning recommended was for the Tobins to execute wills in substantively identical terms, leaving the NRB amount to a NRB trust. The Tobins did not have the liquid assets to satisfy the NRB legacy. Therefore, it was anticipated that upon the death of the first partner, the surviving spouse would need to settle the legacy by a promise to pay.

Mr Tobin died and subsequently there was a promise to pay in relation to Mr Tobin's share of the family home. This allowed Mrs Tobin to continue living in the family home with her disabled daughter.

The technical issues

In order for the promise to pay arrangement (and the NRB trust) to function, it was necessary that the family home was held by Mr and Mrs Tobin as 'tenants in common', not as joint tenants.

Tax advisers may not need to advise regularly on aspects of land law, but it is essential that we have a good understanding of the basics (see Box 2). In *Chadda*, the key issue for the court to decide was whether or not the Tobins held the family home as joint tenants or tenants in common. This distinction was the difference between Mr Tobin's nil rate band being used to its full extent and it not being used at all.

Box 2 – Joint tenancy versus tenancy in common

Where more than one individual holds a property together, they can hold it either as joint tenants or as tenants in common. The key difference is that where a property is held by joint tenants, on the death of one of the parties, the deceased's share passes by survivorship. This means that it will not pass under the deceased's will, but instead will pass directly to the other joint tenant.

Where there is a joint tenancy, the deceased's share in the matrimonial home cannot pass into a NRB, trust because it is not subject to the will. In the event that there is a NRB trust established by will, it is therefore essential that the property is held as tenants in common. If it is held as joint tenants, it is necessary to sever the joint tenancy so that the deceased's share of the property can pass under the will.

The Tobins had held their property as joint tenants and the advisers had recognised that it was necessary to sever the joint tenancy. To sever a joint tenancy, there must be compliance with the Law of Property Act 1925 s 36. This provides:

'(2) No severance of a joint tenancy of a legal estate, so as to create a tenancy in common in land, shall be permissible, whether by operation of law or otherwise, but this subsection does not affect the right of a joint tenant to release his interest to the other joint tenants, or the right to sever a joint tenancy in an equitable interest whether or not the legal estate is vested in the joint tenants:

… where … any tenant desires to sever the joint tenancy in equity, he shall give to the other joint tenants a notice in writing of such desire or do such other acts or things as would, in the case of personal estate, have been effectual to sever the tenancy in equity, and thereupon the land shall be held in trust on terms which would have been requisite for giving effect to the beneficial interests if there had been an actual severance.'

First, a joint tenancy of a legal interest can never be severed. This does not prevent the joint tenants of the legal title, who are also joint tenants of the equitable title, from severing the equitable joint tenancy. Therefore, when there is reference to the severance of a joint tenancy, this is to the equitable title (in practice, this part of the provision makes little difference). Second, s 36(2) explains how an equitable joint tenancy may be severed by 'any joint tenant'. This can be by:

- giving a notice in writing; or
- doing something that would be sufficient to sever an equitable joint tenancy in relation to personal property.

The case of *Williams v Hensman* (1861) 1 John & H 546 explains that a joint tenancy can be severed by:

- an act of one of the joint tenants operating on his own share;
- mutual agreement of both joint tenants; or
- any course of dealing sufficient to intimate that the interests of all were mutually treated as constituting a tenancy in common.

In Chadda, it was argued that there had been severance by mutual agreement and/or by a course of dealings.

Severance by notice

The issues here were evidential. While there was some evidence showing that a notice had been produced, the original notice could not be located. In this respect, the judge held:

‘I find on the balance of probabilities that Mr and Mrs Tobin both signed the Notice of Severance in August 2003, that the original of that document was lost while in the hands of their advisers, … and that the unsigned draft document extracted from that firm’s records is in the same form as the lost signed original document. The Notice, which did not need to be signed, was first presented to Mr Tobin for signature, thus notifying him of Mrs Tobin’s wish to sever the joint tenancy; afterwards on the same day it was handed to Mrs Tobin for her to sign, thus confirming her wish to give notice of severance. I am therefore satisfied that the joint tenancy was severed.’

Consequently, it was not necessary for the judge to go on and consider the other methods of severance. He did, however, go on to consider them. The specific evidential problems in Chadda should also serve as a useful reminder to advisers generally that great care needs to be taken in storing paperwork, especially in IHT cases, where wills and other associated documents may be required many years after their execution.

Other methods

Turning to the other methods of severance discussed in Chadda also reveals a number of interesting points. In relation to mutual agreement, the judge concluded that the execution of wills in identical terms, mutatis mutandis, was not sufficient to indicate that a joint tenancy has been severed. He also held, however, that there was no need for a written mutual agreement under s 36. In holding that there had been a mutual agreement to sever the joint tenancy the judge said:

‘I do not think that the context, involving tax planning and seeking a beneficial result based on the use of an available relief by means of a widely used and accepted method of estate tax planning, affects the conclusion to be drawn from the particular facts of the present case …

‘My conclusion on the mutual agreement issue is that on the evidence as a whole, including the wills and the surrounding circumstances, Mr and Mrs Tobin demonstrated a mutual agreement to sever the joint tenancy, as this was the only way in which their agreed objectives could be fulfilled.’

This is interesting for two reasons. First, the judge confirms that no tax avoidance-type approach should be taken to NRB trusts and that the evidence had to be considered in the round. Thus, the mutual agreement was evidenced by the wills in conjunction with other circumstances.

In relation to the ‘course of conduct’, the judge simply said:

‘If I am not correct in concluding that there was mutual agreement between Mr and Mrs Tobin that the joint tenancy in equity should be severed, I consider that all the matters which I have taken into account under the “mutual agreement” heading above lead to the conclusion that the joint tenancy was severed by their mutual conduct.’

This indicates that there is some similarity between the mutual agreement and course of conduct methods of severance. This is, perhaps, expected, because when there has been mutual agreement the former joint tenants would be likely to treat the tenancy as severed in any event.

Conclusions

In this case, the taxpayer prevailed, as the tribunal accepted that the joint tenancy had been severed. Consequently, the tax planning to utilise both of the NRBs was effective.

In terms of avoiding the issues raised by this case, it is essential to establish how the property is held. If it is held as joint tenants, the joint tenancy must be severed. In terms of dealing with HMRC, the safest approach to severance will be by notice. Such notice must be kept safely, as it may be required.

In the event, however, that there has been no notice, it is also important to remember that there are other methods of severance and that these may have been utilised, even in a situation where there has been no advice. In such cases, it will be necessary to establish reliable and contemporaneous evidence of the severance in case it is required by HMRC.