When tax meets law: the legal red flags

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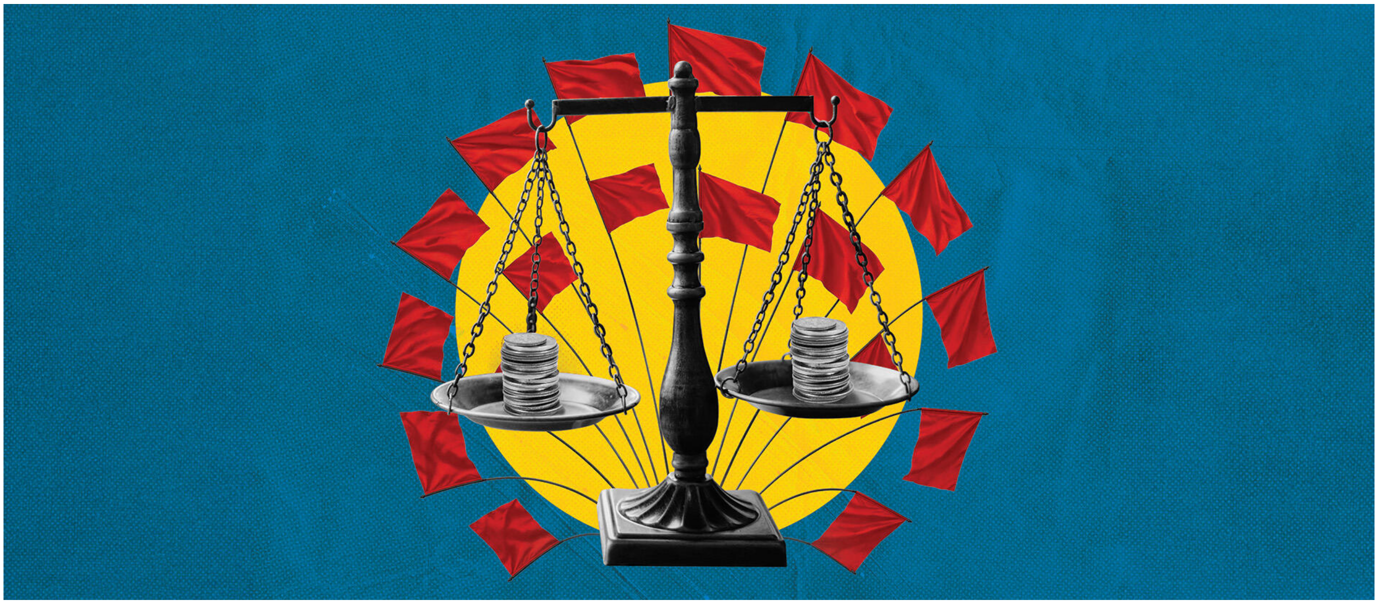

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A private client solicitor's 'red flag' guide to spotting when a tax question becomes a legal issue.

Key Points

What is the issue?
Tax and law frequently overlap in private client work. Tax advisers need to recognise when a tax question depends on establishing, creating or interpreting legal rights and legal input may be required.

What does it mean to me?
Advisers should look for red flags, including uncertain ownership, undocumented family arrangements, trusts, estate disputes, questions of capacity and requests to

draft or amend legal documents.

What can I take away?
The key is knowing when to involve a lawyer. Early, specific referrals can establish the legal position on which the tax analysis depends, while allowing the tax adviser to retain an important role.

Tax advisers are often the first professionals to hear the full story. A taxpayer comes in asking about inheritance tax planning and, 45 minutes later, you know about their second marriage, the cottage they transferred to their daughter, the audacity of their eldest son's wife and the fact that nobody has spoken to Auntie Joan since Christmas 2019.

It is one of the blessings, and sometimes one of the curses, of private client work. The problem is that tax and law are rather fond of travelling together yet are often tackled by separate professions in isolation from one another. A perfectly legitimate tax question can very quickly become a question about ownership, capacity, trusts, succession, contracts, matrimonial rights or even litigation.

From the perspective of a private client lawyer, the skill is not knowing everything about the law. It is recognising the red flags that tell you when another professional needs to be brought into the conversation. So it seems appropriate to mirror that courtesy by providing a summary of when you may need a lawyer to step in.

Red flag 1: After the event

'I've already done it. Can you just tell me the tax consequences?' This is probably the most dangerous sentence in private client work. For example, a taxpayer tells you that her father transferred his house to her three years ago, but that he still lives there. She just needs to know 'if there could be any problems later on'.

The tax answer may depend on establishing what happened legally:

- Who is registered at HM Land Registry?
- Was there a declaration of trust?
- What were the intentions of the parties?

- Was consideration paid?
- Was it intended as a gift?
- Was there an agreement allowing her father to occupy the property?
- Does her father pay a market rent?

These questions may be essential to the tax analysis, but that does not mean that the tax adviser should investigate every legal issue. Advisers cannot be expected to determine the legal validity or interpretation of a historic document, transaction or arrangement. The important thing is to recognise when the underlying legal position needs to be established before the tax analysis can safely proceed.

That may be the point to say: 'Before we finalise the tax advice, I think we should have the legal position checked.'

Red flag 2: Family arrangements

'The family says that it's all understood.' Private client lawyers are naturally suspicious of the phrase 'It's all understood.' It often means that an arrangement exists entirely in the family's collective memory, without the documentary evidence to back it up.

For example, a mother may own the family home, but her son has paid for an extension on the understanding that he will be repaid from the property after her death. Alternatively, a father may have contributed £200,000 towards his child's property purchase without documenting whether the payment was a gift or a loan.

The tax adviser needs to establish the nature of the arrangement before determining its tax treatment. Was the £200,000 a loan or a gift? Who has beneficial ownership of the property? From a legal perspective, the question is what rights actually exist. That can involve trusts, resulting trusts, constructive trusts, loans, gifts or contractual arrangements.

If family members disagree about the arrangement, tax planning can quickly become a legal dispute. The safest response is not to decide who owns what on the taxpayer's account of events alone, but to seek legal advice on the rights involved and the supporting evidence.

Occasionally, the taxpayer also wants a retrospective ‘fix’ to document what they say was an earlier agreement. They may say that a payment was always intended to be a loan, that someone was meant to own half of a property or that a parent appeared on the title only for convenience. They may then ask whether a declaration of trust can simply be put in place now.

The danger is that the desired tax result starts to shape the account of what happened historically. There may be entirely legitimate ways of documenting or correcting arrangements, but retrospective documentation can create significant legal and evidential issues. A lawyer can help establish what legal rights already existed, what documentation is appropriate now and whether the proposed document accurately records the parties’ intentions and circumstances.

Red flag 3: Drafting documents

‘Can you just change the wording?’ This is a classic. A tax adviser may be helping a taxpayer to consider their overall estate planning when the conversation moves from ‘Will this save inheritance tax?’ to ‘Could you word it so that my daughter gets the house but my son receives the equivalent value?’ The next request may be: ‘Can you draft something for me to sign?’

The tax adviser may understand exactly what tax outcome is being sought, but drafting the document raises different questions, including testamentary intentions, trusts, powers, conditions, interpretation and the legal effect of the wording.

Will writing is not a reserved legal activity under the Legal Services Act 2007. It is therefore important not to oversimplify the regulatory position. However, that does not make drafting a will simply an extension of tax advice. The Solicitors Regulation Authority identifies general legal advice and will writing as legal activities, even where the activity is not reserved.

In practice, the tax adviser should ask whether they are explaining the tax consequences of a document or being asked to create or amend the legal document itself. There is an important distinction between the two. Where the request moves into legal drafting, the safer course is to seek legal assistance.

Red flag 4: Trust planning

'Can I put it into a trust?' Trusts are where tax and law become particularly intertwined.

There may be perfectly good reasons for a tax adviser to recommend a trust from a tax perspective. But once the conversation turns to who will own the assets, who should benefit and when, what powers the trustees should have, or what happens on death or if circumstances change, legal advice may be needed.

Consider a taxpayer who wants to put £500,000 into trust for their grandchildren while retaining the ability to recover the money if they later need it. The tax consequences may form part of the planning discussion, but whether those objectives can be achieved together depends on the legal nature and terms of the trust. A lawyer can help translate the tax objectives into legally effective documentation and, importantly, identify where the taxpayer's tax and wider objectives may conflict.

Red flag 5: After a death

'Can you help us sort out the estate?' Death changes the landscape. An adviser who previously dealt with a taxpayer's affairs may suddenly be asked to deal with probate, interpret the will or advise on a family member's claim to property based on a promise made by the deceased. What initially appears to be a simple estate can quickly become complicated. Questions may arise about the validity or interpretation of the will, lifetime gifts, trusts, capacity, proprietary estoppel or disputes between beneficiaries.

There is also an important regulatory boundary. Probate work is a reserved legal activity in England and Wales to the extent that it involves preparing papers on which to found or oppose a grant of probate or letters of administration. This work must therefore be undertaken by, or under the supervision of, an appropriately authorised person.

The tax adviser can still play an important role in estate administration, particularly in relation to inheritance tax, capital gains tax and income tax reporting, but should be clear about where their role ends and legal advice begins.

Red flag 6: Second-hand advice

‘My solicitor said the property is jointly owned. Is that all you need to know?’ This is a red flag that should not be ignored. A taxpayer’s recollection of legal advice may not provide enough information on which to base the tax analysis.

For example, a taxpayer may say that their solicitor confirmed that a property is ‘jointly owned’. But that description can cover very different arrangements, including ownership as joint tenants or tenants in common, equal or unequal beneficial interests, or arrangements involving a declaration of trust or a life interest. The precise legal position can have very different tax consequences.

Similarly, a taxpayer may explain that a solicitor ‘dealt with’ a trust some years ago. That does not necessarily establish what the trust documentation provides or whether the taxpayer’s understanding of it is correct.

Rather than relying on second-hand descriptions, ask to see the relevant documents. If the legal position remains unclear, seek clarification from a lawyer before relying on it for the tax analysis.

Red flag 7: Family disputes

‘What if my sister and I can’t agree about the estate?’ Disagreement between family members is one of the clearest signs that a matter may be moving beyond tax planning. A question about the tax treatment of an estate can quickly develop into a dispute over accounts, assets or the actions of an executor or beneficiary.

Disputes involving beneficiaries, executors, trustees or the ownership of assets can rapidly become contentious legal matters. The conduct of litigation is also a reserved legal activity under the Legal Services Act 2007.

The tax adviser should not become an accidental family mediator simply because they are the professional everyone trusts enough to tell the truth to. Where a dispute is developing, it may be better to involve a lawyer before anyone takes further action.

That is not abandoning the taxpayer. It is recognising that the nature of the problem has changed.

Red flag 8: Capacity and pressure

‘Should I transfer the asset if my family says it’s the right thing to do?’ Tax advisers can be well placed to spot signs that something may be wrong. An elderly taxpayer may suddenly want to transfer a substantial asset to a new friend, a family member may answer questions on their behalf, or the taxpayer may appear not to understand the transaction they are being asked to undertake.

These are not merely tax planning considerations. They may raise questions about mental capacity, undue influence, duress or the validity of a transaction or testamentary document.

Solicitors Regulation Authority guidance for tax advisers also identifies unusual gifts in wills and undisclosed assets in estate administration as potential warning signs.

The appropriate response is not necessarily to refuse to advise. It is to recognise when independent legal advice may be needed. A lawyer may need to speak directly to the taxpayer and, where there are concerns about their ability to make the relevant decision, consider whether a mental capacity assessment is appropriate.

Working together

A useful rule of thumb is that if the question is how much tax is due, think tax. If it is about who is entitled to what, think legal. Of course, the two often overlap, which is precisely why early collaboration matters.

A referral should not simply mean telling the taxpayer: ‘That’s legal. Speak to a solicitor.’ Instead, explain why legal input is needed and how it relates to the tax advice. For example, a lawyer may need to confirm the nature and extent of the parties’ beneficial interests in a property, and whether an existing declaration of trust reflects that position, before the tax analysis can be finalised.

Being specific about the legal question also makes the handover more effective. The taxpayer may already have a lawyer, or the tax adviser may be able to recommend someone or make a direct introduction.

The boundary works both ways. A lawyer should not assume that the tax adviser is merely there to calculate the tax. The best private client work is collaborative: the tax adviser may identify a planning opportunity that the lawyer has not considered, while the lawyer may identify a legal issue that fundamentally changes the tax analysis.

Good professional collaboration should feel like a smooth relay race, not a game of professional hot potato. Neither professional needs to know everything. The important thing is recognising when the other needs to be involved.

In conclusion

One final test can help to identify when that point has been reached: if changing the answer would require changing someone’s legal rights, stop and think.

Whether a gift is a potentially exempt transfer for inheritance tax purposes is a tax question. Whether the taxpayer can make that gift, whether they still own the asset afterwards, whether someone else has an interest in it or whether legal documentation is needed to give effect to it are legal questions.

Tax and legal questions will inevitably overlap in private client work. The skill lies not in trying to answer every question, but in recognising when the tax analysis depends on legal rights that need to be established first.

The most expensive legal problems are often not the ones nobody saw coming. They are the ones everyone saw but assumed were somebody else’s problem.

When to involve a lawyer

Tax advisers routinely need to understand legal concepts and may quite properly explain the legal framework underpinning their tax analysis. The important distinction is between explaining the tax consequences of existing legal rights and creating, determining or enforcing those rights.

A useful starting question is: Am I being asked about the tax consequences? If so, the matter is likely to fall within the tax adviser’s role. But consider involving a lawyer if the answer to any of the following questions is yes:

- Am I being asked what legal rights someone has?
- Am I being asked to create or amend those rights?
- Is there disagreement about those rights?

- Does the answer depend on a document I haven’t seen or whose legal effect is unclear?
- Is litigation, property registration, probate or another reserved legal activity involved?

The aim is not to draw an artificial boundary between tax and law, but to recognise when the tax analysis depends on a legal question that needs to be resolved first.

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