

Trustees' taxing mistakes - Supreme Court applies a likeability test

The rule in *Hastings-Bass* allowed the court to set aside decisions made by trustees if the decisions had unintended consequences, usually as to tax. This ability to remedy past mistakes was restricted by the Court of Appeal's seminal decision in *Pitt v Holt*, a decision now affirmed by the Supreme Court. The rule applies only if the trustees have committed a breach of duty. Following apparently competent advice will not in general constitute a breach of duty. Even if the rule applies, the court has a discretion not to set aside the decision. The only window left open is the court's jurisdiction to set aside a voluntary disposition on grounds of mistake. The Supreme Court softened the Court of Appeal's position marginally, deciding that this simply requires there to be a causative mistake of sufficient gravity.

The rule in *Hastings-Bass*

The rule in *Hastings-Bass* rested on the proposition that, in exercising their powers, trustees must take into account relevant factors, ignore irrelevant factors, and not act capriciously. If the trustees took a step but later realised that this step gave rise to adverse tax consequences, the trustees could start court proceedings arguing that they had innocently failed to take into account a relevant factor, namely the correct tax implications, and, as a result, that their decision should be set aside. The only party likely to lose was Her Majesty's Revenue & Customs, but HMRC did not challenge this approach - until now. HMRC took a major role in *Pitt v Holt* and the case heard with it on appeal, *Futter v Futter*.

This ability to remedy past mistakes was not available to others and, as we noted in our March 2011 client briefing, *Trustees mistakes: the end of the morning after pill*, was heavily circumscribed by the Court of Appeal's seminal decision in *Pitt v Holt*. The Supreme Court ([2013] UKSC 26) has now largely upheld the Court of Appeal's decision.

Excessive execution and inadequate deliberation

In both *Pitt v Holt* and *Futter v Futter*, trustees of discretionary trusts had exercised powers in a manner that turned out to have adverse tax consequences. In one case, this was because of incorrect advice from the trustees' lawyers; in the other, the trustees did not receive advice on the relevant tax point at all.

The Supreme Court approved the Court of Appeal's distinction between an error by trustees in acting outside

Key issues

- The ability of trustees to escape adverse tax consequences is cut back, placing trustees in a position closer to that of the rest of the population
- The jurisdiction is only available if the trustees have acted in breach of duty or, in rare cases, on the basis of a fundamental mistake
- Claims against advisers may now represent a more attractive means for trustees to remedy mistakes
- HMRC is likely to scrutinise closely attempts to undo decisions and thereby to reduce tax

their powers (“excessive execution”) and an error in failing to give proper consideration to relevant matters in making a decision which is within the scope of their powers (“inadequate deliberation”).

In excessive execution cases, the trustees’ act is void. But in inadequate deliberation cases, the trustee’s decision is only voidable, ie liable to be set aside by the court. The court will only set aside the decision if it was made by the trustees in breach of their duties.

The typical case of inadequate deliberation is when the trustees have the power to make an appointment

Effect in offshore jurisdictions?

It remains to be seen whether *Pitt v Holt* will be followed in offshore centres but where jurisdictions closely follow English trusts law, such as Bermuda, the Cayman Islands, Jersey and Guernsey to name but a few, that may well prove to be the case.

Clearly, the view of the trusts community on the effect of *Pitt v Holt* has been pending awaiting the Supreme Court’s judgment. Now we have that affirmation of the Court of Appeal’s decision, it will be interesting to see the consequences for trusts disputes going forward.

We will be returning to *Pitt v Holt* in a future briefing note to assess the views of the offshore trusts community on how far they expect that their jurisdictions will follow the Supreme Court’s decision in this case.

but fail to take proper account of the tax consequences of implementing their decision. However, if the trustees sought advice from apparently competent advisers as to the implications of the course they proposed, and followed the advice, the trustees will not in general be acting in breach of their fiduciary duty even if the advice turns out to have been materially wrong. The rule in *Hastings-Bass* therefore has no application.

Further, even if the trustees have acted in breach of their duties, the court has a discretion not to set aside their decision, taking into account, for example, the effect on third parties and beneficiaries.

The Supreme Court warned trustees that it is not in general for them to apply to have their own decisions set aside under the rule in *Hastings-Bass*. Beneficiaries or other affected parties should do so. The Supreme Court also commented that, if an application is made, the trustees should not assume confidently that they will be able to recover their costs from the trust fund (though this may depend upon the terms of the trust). The Supreme Court’s decision may therefore place trustees in a difficult position, potentially rendering claims against advisers more attractive.

On the facts of *Futter*, the trustees made distributions to their beneficiaries believing that there would be no adverse CGT consequences. They had been advised to that effect by professional advisers. Although one of the trustees was himself a member of the firm of advisers, he was not personally involved in the giving of the advice and so the Supreme Court held that he should not be treated as having been personally in breach of fiduciary

duty. Absent a breach of fiduciary duty, the *Hastings-Bass* rule did not apply, even though there was no dispute that the tax advice was wrong.

In *Pitt*, the trustee had been advised about certain of the tax consequences of the trust that she was setting up but the advice had failed to address the IHT position. The Supreme Court held that there was no reason to hold that the trustee personally failed in the exercise of her fiduciary duty, and so again the trust could not be unwound on the basis of the *Hastings-Bass* rule.

Rescission on the ground of mistake

Pitt v Holt also raised issues as to the jurisdiction of the court to set aside a voluntary disposition on grounds of mistake. The Supreme Court allowed the appeal in *Pitt v Holt* on this basis and set aside the discretionary settlement which was the subject of that case.

The Court of Appeal had restricted the courts’ ability to grant relief on this basis, finding that a decision by trustees can only be set aside if the mistake is either as to the legal effect of the transaction (not as to its tax or other legal consequences) or as to an existing fact that was basic to the transaction proposed by the trustees. Further, the Court of Appeal held the mistake must be so serious as to render it unjust for the person in whose favour the decision has been made to retain the property in question.

However, the Supreme Court has developed the law by allowing the appeal in *Pitt*. The Supreme Court held:

- The requirement for rescission on the ground of mistake is simply

that there is a causative mistake of sufficient gravity. The test for this will normally be satisfied only when there is a mistake either as to the legal character or nature of the transaction, or as to some matter of fact or law which is basic to the transaction.

- Consequences (including tax consequences) are relevant to the gravity of the mistake, whether or not they are basic to the transaction.
- A mistake must be distinguished from mere ignorance, inadvertence, or misprediction. Forgetfulness, inadvertence or ignorance is not, as such, a mistake, but it can lead to a false belief or assumption which the law will recognise as a mistake.
- The gravity of the mistake must be assessed by a close examination of the facts, including the circumstances of the mistake and its consequences for the person who made the vitiated disposition.
- The injustice (or, as Lord Walker put it, "to use equity's cumbersome but familiar term, unconscionability") of leaving a mistaken disposition uncorrected

must be evaluated objectively, but with an intense focus on the facts of the particular case. The court must consider in the round the existence of a distinct mistake, its degree of centrality to the transaction in question and the seriousness of its consequences, and make an evaluative judgment whether it would be unconscionable to leave the mistake uncorrected.

Turning to the facts, the Supreme Court plainly had great sympathy for Mrs Pitt, whose husband had died many years after a road traffic accident. The compensation awarded to him had been placed in a trust. The trust could easily have been set up to minimise inheritance tax but the advisers mistakenly failed to do so. The Supreme Court held that there would have been nothing artificial or abusive about Mrs Pitt's establishing the trust so as to obtain protection from inheritance tax under the relevant legislation and, on that basis, set the trust aside.

In the *Futter* case, mistake had not been pleaded. The Supreme Court refused to allow the point to be argued but Lord Walker noted that if mistake had been raised, there would

have been an issue of some importance as to whether the Court should assist in extricating claimants from a tax avoidance scheme that had gone wrong.

The scheme adopted by Mr Futter was said to be by no means at the extreme of artificiality but it was hardly "an exercise in good citizenship". Plainly, the Supreme Court had in mind that in some cases of artificial tax avoidance the court might refuse relief. In fairly strong terms but perhaps picking up on a present mood of governments and revenue authorities around the globe, Lord Walker said that there has been an increasingly strong and general recognition that artificial tax avoidance is "a social evil which puts an unfair burden on the shoulders of those who do not adopt such measures".

In conclusion, these types of cases are heavily fact sensitive, but where the Court is persuaded that a serious mistake has been made and that, in all fairness, a remedy should be found, it has the legal mechanism to do so, even if the mistake relates to the tax consequences of what was done.

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