LOOKING AFTER LEVIATHAN: SETTING ASIDE TRUSTEE DECISIONS ON THE GROUNDS OF MISTAKE

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Introduction

1. The purpose of this talk is to identify the differences between the remedies available to trustees in England and Wales and trustees in offshore jurisdictions where they have entered into a transaction mistakenly believing that it will either have beneficial tax consequences or that it will not have adverse tax consequences in England and Wales. The reason why this issue has come into such sharp focus in recent years is the willingness of HMRC to challenge or oppose Court applications to set aside transactions which have adverse tax consequences.

2. The decision of the English Court of Appeal in *Pitt v Holt* [2012] Ch 132 caused a stir in 2011 because it severely limited the options for trustees who had made tax mistakes. It was not uniformly well received or followed in offshore jurisdictions and the reference in my title to Leviathan is to a much-quoted passage in the decision of Sir Philip Bailhache, Commissioner, in *Re the S Trust* (2011) 14 ITELR 663 at [39]:

   "The preference accorded to the interests of the tax authority in the UK is not one, however, with which we are sympathetic. In our view, Leviathan can look after itself. We should not be taken as indicating any sympathy for tax evasion, which we regard as fraudulent and as entirely undeserving of any favourable discretionary treatment. But in Jersey it is still open to citizens so to arrange their affairs, so long as the arrangement is transparent and within the law, as to involve the lowest possible payment to the tax authority. We see no vice in this approach. We accordingly see no reason for adopting a judicial policy in this country which favours the position of the tax authority to the prejudice of the individual citizen, and excludes from the ambit of discretionary equitable relief mistakes giving rise to unforeseen fiscal liabilities. We see no fairness in such a policy. If, as we understand it, Mrs Pitt had arranged her affairs differently, the compensation that her husband received for his terrible injuries would not have been subject to IHT. We do not think that many people would have criticised her for making such a different arrangement so long, of course, that it was transparent and lawful."

Tax Mistakes

3. There are three remedies which are potentially available to trustees who make tax mistakes:

   - The application of the (so called) rule in *Re Hastings-Bass* [1975] Ch 25;
   - Rescission for equitable mistake; and
   - Rectification.

4. In this paper, I am not going to consider rectification but concentrate on circumstances where the trustees or beneficiaries wish to set aside the entire transaction. Where the trustees or beneficiaries are able to make out a case for rectification of a document and the Court orders rectification, HMRC has long accepted that document is to be treated as if it contained the rectified words.

Hastings-Bass

5. I refer to the (so-called) rule in *Hastings-Bass* because there was for many years a debate about precise what the rule was. I am reminded of the dictum of Mummery LJ in *Swindle v*

Harrison [1997] 4 All ER 705 at 731-2 when discussing *Nocton v Lord Ashburton* [1914] AC 932:

"The decision of the House of Lords in Nocton v Lord Ashburton is the seminal case, although, as Lord Devlin observed in Hedley Byrne & Co Ltd v Heller & Partners Ltd 604, [1964] AC 465 at 520, 'it is not at all easy to determine exactly what it decided'. That is a common characteristic of pathbreaking cases: it may take a generation or more to work out the ramifications of broad statements of legal principle."

6. Before *Pitt v Holt* it was widely accepted that there was a rule derived from the decision in *Hastings-Bass* and that a trustee decision was void if it involved the following elements (as set out by Lloyd J in *Sieff v Fox* [2005] 1 WLR 3811 at [119](i)):

"Where trustees act under a discretion given to them by the terms of the trust, in circumstances in which they are free to decide whether or not to exercise that discretion, but the effect of the exercise is different from that which they intended, the court will interfere with their action if it is clear that they would not have acted as they did had they not failed to take into account considerations which they ought to have taken into account, or taken into account considerations which they ought not to have taken into account."

7. However, one observation made by Lloyd LJ in *Sieff v Fox* was that the Court's task might be easier if HMRC did not always decline the invitation to take part in cases involving the principle and HMRC took up this challenge. In Tax Bulletin 83 (June 2006) HMRC stated that it would in future give active consideration to participating in future cases:

"An interesting, but perhaps not surprising, feature of the majority of these cases is that the unintended consequence of the mistake by the trustees was a liability to tax. For this reason HMRC have been interested in this area of the law, as it develops and is shaped by the courts. In recent years it has been the usual practice of HMRC to decline invitations to be joined as a party in cases where the court is being asked to set aside a transaction in reliance on the principle. However, in Sieff v Fox Lloyd LJ observed in paragraph 83 that the court's task might be easier in some cases if HMRC did not always decline the invitation to take part in cases of this kind. In the light of that observation, and our increasing concern (which is shared by many commentators) that the principle as currently formulated is too wide in its scope, HMRC will now give active consideration to participating in future cases where large amounts of tax are at stake and/or where it is felt that we could make a useful contribution to the elucidation and development of the principle. We will be particularly ready to intervene in cases where there would otherwise be no party in whose interest it would be to argue against the application of the principle."

8. In the conjoined appeals *Pitt v Holt* and *Futter v Futter*, HMRC were represented and opposed an order setting aside the relevant transactions. In *Pitt v Holt* the transfers of the proceeds of a personal injury settlement into a discretionary trust triggered large inheritance tax liabilities. In the second case, trustees transferred assets out of a trust with a view to avoiding capital gains tax but their solicitors overlooked a statutory provision which triggered large tax liabilities. The Court of Appeal rejected the widely held view and held that there was no such rule: see [95]. They held that an exercise of a discretion which was within the powers of the trustee could only be set aside where there was a breach of duty by the trustees but would remain valid until challenged: see [99] to [101].

9. The decision had two practical consequences: first, where the trustees had relied on professional advice but the advice was wrong, they could not reverse the transaction but would be left with a remedy against the adviser.Secondly, this effectively put an end to applications by trustees to reverse the transaction and it was now a matter for the beneficiaries.

Equitable Mistake

10. In *Pitt* the Court of Appeal also dealt with equitable mistake. Lloyd LJ endorsed the principle set out by Lindley LJ in *Ogilvie v Littleboy* (1897) 13 TLR 399:

"Gifts cannot be revoked, nor can deeds of gift be set aside, simply because the donors wish they had not made them and would like to have back the property given. Where there is no fraud, no undue influence, no fiduciary relation between donor and donee, no mistake induced by those who derive any benefit by it, a gift, whether by mere delivery or by deed, is binding on the donor … In the absence of all circumstances of suspicion a donor can only obtain back property which he has given away by showing that he was under some mistake of so serious a character as to render it unjust on the part of the donee to retain the property given to him."

11. However, they also held that the relevant mistake had to be either as to the legal effect of the disposition or as an existing fact which was basic to the transaction. Lloyd LJ said this at [210]:

"I would therefore hold that, for the equitable jurisdiction to set aside a voluntary disposition for mistake to be invoked, there must be a mistake on the part of the donor either as to the legal effect of the disposition or as to an existing fact which is basic to the transaction. (I leave aside cases where there is an additional vitiating factor such as some misrepresentation or concealment in relation to the transaction, among which I include Dutton v Thompson 23 Ch D 278.) Moreover the mistake must be of sufficient gravity as to satisfy the Ogilvie v Littleboy test 13 TLR 399, 400, which provides protection to the recipient against too ready an ability of the donor to seek to recall his gift. The fact that the transaction gives rise to unforeseen fiscal liabilities is a consequence, not an effect, for this purpose, and is not sufficient to bring the jurisdiction into play."

12. As the passage indicates, the effect of the effect and consequences distinction is that trustees would not be able to invoke the mistake doctrine to set aside transactions which had adverse tax consequences which the trustees had not anticipated.

The Offshore Response

Jersey

13. Jersey was the first jurisdiction to consider *Pitt v Holt*. In *Re the S Trust* (2011) 14 ITELR 663, the settlor settled assets on a discretionary trust after receiving advice that there would be no inheritance tax. She applied to set aside the settlement for mistake when it became clear that she would become liable for £2m in inheritance tax and that the US beneficiaries would be taxed up to 100% of their entitlements. The Royal Court declined to follow *Pitt* and set aside the transfer for mistake.

14. Jersey also passed an amendment to the Trusts (Jersey) Law Act 1984 introducing new Articles 47B to 47J to avoid a conflict with the English Courts. Articles 47 G and 47H now provides:

*"**47G Power to set aside the exercise of powers in relation to a trust or trust property due to mistake***

(1) In this paragraph, "person exercising a power" means a person who, otherwise than in the capacity of trustee, exercises a power over, or in relation to a trust, or trust property.

*(2)The court may on the application of any person specified in Article 47I(2), and in the circumstances set out in paragraph (3), declare that the exercise of a power by a trustee or a person exercising a power over, or in relation to a trust, or trust property, is voidable and – (a) has such effect as the court may determine; or **(**b) is of no effect from the time of its exercise.*

(3) The circumstances are where the trustee or person exercising a power – (a) made a mistake in relation to the exercise of his or her power; and (b) would not have exercised the power, or would not have exercised the power in the way it was so exercised, but for that mistake, and the mistake is of so serious a character as to render it just for the court to make a declaration under this Article.

47H Power to set aside the exercise of fiduciary powers in relation to a trust or trust property

(1) In this paragraph, "person exercising a power" means a person who, otherwise than in the capacity of trustee, exercises a power over, or in relation to a trust, or trust property and who owes a fiduciary duty to a beneficiary in relation to the exercise of that power.

(2) The court may on the application of any person specified in Article 47I(2), and in the circumstances set out in paragraph (3), declare that the exercise of a power by a trustee or a person exercising a power over, or in relation to a trust, or trust property, is voidable and – (a) has such effect as the court may determine; or (b) is of no effect from the time of its exercise.

(3) The circumstances are where, in relation to the exercise of his or her power, the trustee or person exercising a power – (a) failed to take into account any relevant considerations or took into account irrelevant considerations; and (a) would not have exercised the power, or would not have exercised the power in the way it was so exercised, but for that failure to take into account relevant considerations, or that taking into account of irrelevant considerations.

(4) It does not matter whether or not the circumstances set out in paragraph (3) occurred as a result of any lack of care or other fault on the part of the trustee or person exercising a power, or on the part of any person giving advice in relation to the exercise of the power."

Bermuda

15. Bermuda also passed a similar amendment to the Trustee Act 1975. Section 47A of the Act now provides:

"Jurisdiction of court to set aside flawed exercise of fiduciary power

(1) If the court, in relation to the exercise of a fiduciary power, is satisfied on an application by a person specified in subsection (5) that the conditions set out at subsection (2) are met, the court may— (a) set aside the exercise of the power, either in whole or in part, and either unconditionally or on such terms and subject to such conditions as the court may think fit; and (b) make such order consequent upon the setting aside of the exercise of the power as it thinks fit.

(2) The conditions referred to in subsection (1) are that— (a) in the exercise of the power, the person who holds the power did not take into account one or more considerations (whether of fact, law, or a combination of fact and law) that were relevant to the exercise of the power, or took into account one or more considerations that were irrelevant to the exercise of the power; and (b) but for his failure to take into account one or more such relevant considerations or his having taken into account one or more such irrelevant considerations, the person who holds the power— (i) would not have exercised the power; (ii) would have exercised the power, but on a different occasion to that on which it was exercised; or (iii) would have exercised the power, but in a different manner to that in which it was exercised.

(3) If and to the extent that the exercise of a power is set aside under this section, to that extent the exercise of the power shall be treated as never having occurred.

(4) The conditions set out in subsection (2) may be satisfied without it being alleged or proved that in the exercise of the power, the person who holds the power, or any adviser to such person, acted in breach of trust or in breach of duty."

Cayman

16. The only other jurisdiction which had considered the issue was the Cayman Islands and in two decisions, the Grand Court had applied the orthodox interpretation of the rule in *Hastings-Bass* before the decision of the Court of Appeal in *Pitt v Holt*: see *A v Rothschild Trust Cayman Ltd* [2004-05] CILR 485 and *Re Ming Wang Trust* [2010] 1 CILR 541.

The Supreme Court: Futter v Futter

17. On 9 May 2013 the Supreme Court delivered judgment on the appeals from the Court of Appeal in *Pitt v Holt*: see [2013] 2 AC 108. They dismissed the appeal on the *Hastings-Bass* issue but allowed the appeal on equitable mistake. They held that the test for rescission was a causative mistake of sufficient gravity. The Court reserved its position in relation to tax avoidance schemes which have gone wrong: see [135].

18. The Supreme Court decision has already been applied to tax mistakes in two first instance decisions: *Kennedy v Kennedy* [2015] WTLR 837 and *Freedman v Freedman* [2015] EWHC 1457. In *Kennedy* Sir Terence Etherton summarised the relevant principles at [36]:

> *"(1) There must be a distinct mistake as distinguished from mere ignorance or inadvertence or what unjust enrichment scholars call a 'misprediction' relating to some possible future event. On the other hand, forgetfulness, inadvertence or ignorance can lead to a false belief or assumption which the court will recognise as a legally relevant mistake. Accordingly, although mere ignorance, even if causative, is insufficient to found the cause of action, the court, in carrying out its task of finding the facts, should not shrink from drawing the inference of conscious belief or tacit assumption when there is evidence to support such an inference.*
>
> *(2) A mistake may still be a relevant mistake even if it was due to carelessness on the part of the person making the voluntary disposition, unless the circumstances are such as to show that he or she deliberately ran the risk, or must be taken to have run the risk, of being wrong.*
>
> *(3) The causative mistake must be sufficiently grave as to make it unconscionable on the part of the donee to retain the property. That test will normally be satisfied only when there is a mistake either as to the legal character or nature of a transaction or as to some matter of fact or law which is basic to the transaction. 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.*
>
> *(4) The injustice (or unfairness or unconscionableness) 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, or unjust, to leave the mistake uncorrected."*

The Offshore Response

Jersey

19. *Re Onorati ST* [2013] JRC 182 was the first decision of the Royal Court following the decision of the Supreme Court in *Futter*. It was also decided before the amendment to the Trusts (Jersey) Law 1984 had taken effect. In that case it was unnecessary for the Court to consider whether or not to follow *Futter* because the trustee had been in breach of fiduciary duty in failing to take tax advice. The decision does, however, contain an indication of the current views of HMRC at [46] to [47]:

> *"For the sake of completeness, we should add that HMRC was notified of the hearing and was asked whether it wished to make arrangements to attend the hearing. HMRC declined to do so but drew attention to the obiter dicta of William Bailhache DB in the* B Life Interest

Settlement *case. We have of course considered the contents of the letter from HMRC and the dicta of the Deputy Bailiff and taken them fully into account but, for the reasons we have given, we consider that the facts of this case fall fairly and squarely within the principle as articulated by the Supreme Court. The letter goes on to say that HMRC reserves the right to contend that, so far as any UK tax consequences are concerned, any decision of the Royal Court setting aside the 2010 deed on the basis of the rule in* Hastings-Bass *should not be recognised in England. That is of course entirely a matter for HMRC, but the consequence of our decision is that, under the proper law which governs the Trust, the 2010 deed having been avoided, it is as if it never existed."*

20. There have been two decisions by the Royal Court since the amendments to the 1984 Law came into effect: see *Re the Strathmullan Trust* [2014] JRC 56 and *Re Robinson Annuity Investment Trust* [2014] JRC 133. Both were decided under the mistake provisions and are consistent with *Futter v Futter*. It has not been necessary, therefore, for the Court to consider the new statutory rule designed to "preserve" the rule in *Hastings-Bass* or for HMRC to decide whether to oppose any claim made under it.

Guernsey

21. The Royal Court in Jersey has been content to follow the Court of Appeal in *Pitt v Holt* and then the Supreme Court in *Futter v Futter* on mistake: see *Dervan v Concept Fiduciaries Ltd* (2013), *Nourse v Heritage Corporate Trustees Ltd* (2015) (both of which involved mistakes of sufficient gravity to justify rescission) and *HCS Trustees Ltd v Campiero Legal and Fiduciary Services* (2015) where the trustees had acted in breach of fiduciary duty by failing to take advice. Again, none of these decisions involved the Court considering whether to "preserve" the rule in *Hastings-Bass*. None of them involved a tax mitigation scheme or avoidance scheme either.

Other Jurisdictions

22. Elsewhere in the Commonwealth there has been less activity. In a conference in June 2015 Anthony Smellie QC Chief Justice of the Cayman Islands stated that the applicability of the rule in *Hastings-Bass* would have to be reconsidered in the light of *Futter* in the Supreme Court. The Isle of Man has always adopted the wider test for mistake in *Futter* and according to an article by Michael Furness QC and Tiffany Scott in Trusts and Trustees (November 2014) may be considering similar legislation to Jersey. There have been no decisions in Bermuda under section 47A.

Hard Cases

23. The real issue which will arise for offshore jurisdictions is where a trustee or beneficiary applies to set aside a transaction but the test for mistake in *Futter* cannot be satisfied or where the test for mistake is satisfied but the relevant mistake took place in relation to a tax avoidance or mitigation scheme. Ironically, that was the position in *Futter* itself where the claim was originally made under the rule in *Hastings-Bass* alone and the Supreme Court refused to permit the question of mistake to be raised at the appellate stage. Lord Walker described the scheme as "by no means at the extreme of artificiality" but "it was hardly an exercise in good citizenship." Then HMRC may intervene in the offshore proceedings or may choose to reserve its position on the recognition of any judgment by the offshore Court.

The Traditional Rule

24. The traditional rule applied by the English Court to the taxation of foreign trusts is that the English Court or tribunal has to apply the foreign law to determine the rights and liabilities of the parties before applying the English taxing statute. This principle is derived from the decision of the House of Lords in *Garland v Archer-Shee* [1931] AC 212. The principle was

stated in the following way by Robert Walker J in *Memec plc v IRC* [1996] STC 1336 at 1348j (approved by the Supreme Court in *Anson v HMRC* [2015] STC 1777 at [51])

"When an English tribunal has to apply the provisions of an United Kingdom taxing statute to some transaction, arrangement or entity which is governed by a foreign system of law, the tribunal must take account of the rules of that foreign system (properly proved if not admitted) in order to determine the nature and characteristics of the transaction, arrangement or entity. But having informed itself in this way, the tribunal must then apply the taxing statute as part of English law."

25. If the English Court applies the traditional principle it ought to give effect to an order for rescission of a trust made by the Jersey Court under the Trusts (Jersey) Law 1984 or the Bermuda Court under section 47A of the Trustee Act 1975 in Bermuda or by any other offshore jurisdiction which chooses to apply the rule in *Hastings-Bass* as it was originally understood. It would also involve a considerable extension to the principles of private international law if the English Court refused to recognise such a judgment on the grounds of public policy.

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