ADDITIONAL NOTES

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These notes are intended as an aid to stimulate debate: delegates must take expert advice before taking or refraining from any action on the basis of these notes and the speaker can accept no responsibility or liability for any action or omission taken by delegates based on the information in these notes or the lectures.

Correcting tax mistakes

There are mechanisms for correcting mistakes in the tax legislation.

e.g. **Overpayment Relief**

They involve meeting various requirements and time limits.

Not going to look at those. Will look at

- Rectification
- So called “Rule in Hastings Bass”
- Rescission

Each has a potential role to play in correcting a tax mistake.

There are no time limits to applications (Limitation Act 1980 does not apply to equitable remedies) but delay will make it more difficult to obtain relief and in some circumstances may give rise to the defence of laches/acquiescence.

Overview

Rectification

This has the strictest requirements but results in the document being corrected from its inception. Rectification is the only remedy that will potentially remedy the tax treatment and secure the desired treatment without the need for any further document. It is accordingly useful where rescission will not secure the tax treatment desired.

> e.g. It is no longer possible to secure the desired tax treatment (e.g. because the tax treatment depended on the document being executed within a time period that has expired since the document was executed);

The So Called Rule

The so called rule is now of less importance – rescission for mistake will in many cases be available with no obvious disadvantage. The so called rule may be worth considering if there is a fear that the Court might refuse to rescind for mistake because what was being done was aggressive tax avoidance.

Rescission for Mistake

Rescission for mistake does not involve too many requirements. It may be available in circumstances where rectification is not possible and often overlaps with the so called rule. It will result in the transaction being set aside from inception. Accordingly it will be useful where:

- the transaction would not be repeated (e.g. because a tax trap was overlooked); or
- it is possible to obtain the desired treatment by repeating the transaction with the mistake corrected.

In other cases the focus ought to be on rectification. In some of those cases, if rectification is not possible (e.g. because the requisite intention cannot be shown), it may still be worth seeking to set aside for mistake if that will avoid a tax charge.

Rectification

Requirements.

(See e.g. **Giles v RNIB** [2014] STC 163).

1. There must be a flaw in the written document with the result that it does not give effect to the parties' intention, as opposed to the parties merely being mistaken as to the consequences of the document.

2. The specific intention of the parties must be shown.

   It is not sufficient to show that the parties did not intend what was recorded; they also have to show what they did intend, with some degree of precision.

3. There must be a real issue between the parties – if the mistake has been corrected by the parties the Court will not rectify if that will affect only the tax consequences.

   NB Do not have to show that the settlor intended particular wording – sufficient if intended particular effect.

Two principal types of mistake:

(1) a mistake as to content of a document;

  e.g. a missing clause

(2) a mistake as to meaning

  e.g. a term is deliberately included but the settlor misunderstands its meaning.

  Re Butlin [1976] Ch 251

  This is particularly relevant for tax cases.

NB The distinction from construction. Construction involves working out the meaning of a document objectively. Rectification permits the settlor to adduce evidence of his subjective intention and if that evidence is strong enough and there is no other bar to rectification, the document may be rectified.

There is a debate about whether rectification requires the intention to be objectively determined. That generally arises in contractual situations and I shall not explore it here.

Tax Mistakes.

In **Pitt v Holt** [2013] 2 A.C. 108 (para.131) Lord Walker stated:

> ‘Rectification is a closely guarded remedy, strictly limited to some clearly established disparity between the words of a legal document, and the intentions of the parties to it. It is not concerned with consequences.’

In **Gibbon v Mitchell** [1990] 1 WLR 1304 Millett J held that rescission could not be granted where the mistake was about the consequences of a gift. That restriction was rejected on **Pitt** (and so there is now greater scope for the remedy of rescission) but the distinction is alive and kicking as regards rectification.

Cases where a term is omitted or included by mistake generally present no real difficulty. Cases where there was no mistake about the terms are more difficult. They can be divided into two:

(1) Where there is a deliberate decision to include or omit a term and as a result the instrument does not achieve the desired tax result. The settlor (S) intended to include/omit the term. He knew what it meant and its effect but

was mistaken about its tax consequences. S's mistake was about the requirements of tax legislation and the document failed to satisfy S's motive. The document conformed with S's intention.
Rectification will not be granted.

Typical cases are: **Allnut v Wilding** [2007] EWCA Civ 412 and **Racal Group v Ashmore** [1995] STC 1151.

In **Allnut** the relevant document recorded precisely what S had been advised to do. Rectification was rejected because S's mistake was not as to the terms or their meaning but as to the tax consequences. The document failed to carry out S's motive (to save tax) but did carry out S's intention.

In **Racal** the parties' intention was that the deed should result in the covenanted payments being deductible for the payer. That required the payments to be made for more than 3 years. By mistake the deed stated that payments were to be for three years. There was no evidence that the parties intended any other period (other than that it be for more than 3 years). The intention was simply to execute the document. The application accordingly failed.

(2) Where the intention was to achieve a particular fiscal effect and S was advised that a term achieved that effect. In such a case there is no mistake about the terms. But those terms do not achieve the intention. There is a disparity between the S's intention and the wording of the document.

Rectification will be granted.

Typical example are: **Wills v Gibbs** [2007] EWHC 3361 (Ch); **Vaughan-Jones v Vaughan-Jones** [2015] EWHC 1086 (Ch). In those cases the Court accepted that the intention of the settlor was to execute deeds of variation that would take effect for the purposes of IHT (and CGT also in

Wills) as if their provisions had been included in the relevant will. The relevant deed did not contain the statement required by s142 IHTA 1984(or s62 TCGA 1992). The Court rectified the deeds to include the relevant statement.

The line can be hard to draw. One might have expected that the Courts would be reluctant to find that a case fell into the second group – after all in many cases it would be relatively easy to conclude that S intended to execute a document that accorded with his advice rather than to execute a document that satisfied tax requirements.

But in practice the Courts have shown themselves to be relatively willing often on slight evidence to find that S's intention was to achieve a tax result and that the document should contain whatever terms were necessary to do that.

e.g. **Martin v Nicholson** [2004] EWHC 2135 (Ch)

S wanted to set up a nil rate band trust. S declared a trust of £200,000 (being the sum that she was advised was the nil rate band) but band had just been lowered to £154,000. Held: the intention was to create a trust of the nil rate band. The Court considered that the evidence was just on right side of the distinction.

e.g. **Lobler** [2015] UKUT 152 (TCC).

This was a very odd case. T invested in an insurance policy – or more precisely several policies. After two years he withdrew a sum roughly equal to the sum invested. He did so (without advice) by means of choosing a partial surrender of the policies. The tax consequences were disastrous and T was assessed as if he had made a gain of around 90% of the sum withdrawn. Had T surrendered some of the policies completely, the sum received would have been taxed as income.

Surprisingly, the FTT (which could not grant rectification) concluded that if rectification would be granted, the position should be assessed as if rectification had been granted. The Court concluded that rectification (to substitute complete surrender for some policies) would be granted because the tax consequences were such that the effect of the partial surrenders was entirely different from what T believed they would be. This seems to be wrong. T's intention was to make partial surrenders – he would have made a different choice had he appreciated the tax consequences but they were not present to his mind – compare **Tucker v Bennett** (1887) 38 Ch D 1).

In many cases an applicant is assisted by HMRC's practice of not appearing as a party and so the evidence is not tested by cross examination.

Key points to remember:

- Will it be sufficient to show only one person's (S's) intention?
- Was the mistake about the contents of the document or as to meaning?
- The evidence must be strong.
- What evidence is available to show the requisite intention?
    - If necessary to show only S's intention, he can adduce evidence of his subjective intention
    - Better if some objective evidence can be adduced, e.g. instructions to solicitors, attendance notes, other documents etc.
- Can the requisite intention be demonstrated - is this a case where it is necessary to show an intention to execute a document that conformed with specific requirements of tax legislation? Take care to distinguish this from cases where the intention was to execute the document as it stands and the mistake was about the tax consequences.

- Is there an issue between the parties (e.g. S and the trustees).
- Notify HMRC and ask if they wish to be joined as parties.
- Be very careful before trying to correct mistakes out of Court – if you do so it may be too late to rectify (if that is needed).

The so called rule in Hastings Bass.

This was at one time a very popular “get out of jail free” card that was played when trustees made a tax mistake.

The Court was thought to be able to set aside a transaction if trustees had failed to take into account all relevant circumstances (or taken into account irrelevant ones) and they would (or might) have done something different had they acted properly.

The source of this so called rule was the case of **Hastings-Bass.**

It led to cases such as **Abacus v NSPCC** [2001] STC 1344 where a defective tax avoidance scheme (a flip flop scheme) was set aside because wrong advice was given regarding the date on which a document should be executed.

The position was reassessed by the Supreme Court (“SC”) in **Pitt v Holt** [2013] 2 AC 108 and the rule was restated.

In outline the position now is that the court can set aside a transaction where trustees have failed to take into account relevant considerations – including tax - (or omitted to take into account irrelevant ones) but only if they were as a result in breach of duty.

The requirement that the trustees have committed a breach of duty is an important qualification because SC held that when trustees obtain apparently competent professional advice on relevant matters they are not in breach of duty merely because the advice turned out to be wrong.

The result is that – in England- cases such as **Abacus** would no longer succeed and the so called rule is not likely to be a profitable avenue to correct most mistakes about tax. NB that in Jersey and Bermuda the position is different as legislation has the effect that there is no need to prove a breach of duty.

But the SC decided that there was a separate jurisdiction to set aside on the ground of mistake and in many circumstances the so called rule offers will not a real advantage over rescission for mistake.

Rescission

Pitt v Holt confirmed that rescission can be granted for gifts made by mistake. The test is different from that for rectification (and for the application of the so called rule in Hastings-Bass).

A Court may set aside a transaction if there has been:

(1) a mistake that caused the transaction; and

(2) the ***donor*** made a mistake that was so grave that it would be unconscionable for the ***donee*** to retain the property.

If there is no issue between the parties, generally relief will be refused because the second requirement will not be satisfied.

The mistake can be about the legal character or nature of the transaction, or as to some matter of fact or law (e.g. tax) which was basic to the transaction. (This over-ruled **Gibbon v Mitchell** where it was held that transactions could be set aside only if the mistake was about its effect and could not be set aside if the mistake was about its consequences (e.g. tax)).

Unfortunately for those of us who like simple expressions Lord Walker adopted expressions used by commentators to describe the different sorts of mistake.

In short:

1. **Sufficient Mistakes**

    Incorrect conscious mistake.

    This where someone makes a gift because he consciously but wrongly believes something to be true. That is sufficient.

    Incorrect tacit assumption

    This is where someone makes a gift on the mistaken assumption that something is true. That is sufficient.

2. **Insufficient Mistakes**

    Misprediction

    This is where someone makes a gift in the hope or expectation that something would happen. This is insufficient.

Causative ignorance

> This is where someone makes a gift without a belief or assumption about a fact and who would not have made the gift had he been told about the fact. That is insufficient.

> It can be difficult in some cases to decide which type of mistake has been made. Ultimately it turns on the evidence.

It does not matter that the mistake is due to carelessness (unless S deliberately took the risk of being wrong).

The mistake need not be known to the donee.

A mistake about tax consequences is suffices if sufficiently serious.

There is a further point that should be considered. In **Pitt**, Lord Walker stated:

> "In some cases of artificial tax avoidance the court might think it right to refuse relief, either on the ground that such claimants, acting on supposedly expert advice, must be taken to have accepted the risk that the scheme would prove ineffective, or on the ground that discretionary relief should be refused on grounds of public policy."

The first suggestion – acceptance of risk – is a question of fact and is unobjectionable.

The second – public policy – is more difficult.

It was stated in connection with a mild type of “tax avoidance” - trustees of a previously off-shore settlement decided to distribute to beneficiaries believing that the beneficiaries could set off losses made by them against the stock piled gains attributed to them.

There are difficulties with the statement. If trustees have indulged in “artificial” tax avoidance is an uninvolved beneficiary to be denied relief? (If the so called rule is in play the answer is probably no). It has not found favour with the Courts as yet. (**Van de Merwe** [2016] EWHC 790 (Ch)); **Kennedy v Kennedy** [2014] EWHC 4129 (Ch)). And unsurprisingly off shore jurisdictions have been loath to adopt it – see e.g. **Strathmullen** [2014] JRC 56; **Schroder Cayman Trust Co Ltd v Schroder Trust AG** (2015) 18 ITELR).

If setting aside will cure the tax problem (s150 IHTA 1984 says as much) this route is worth considering. In many cases it will do so but in some circumstances rescission will not cure the problem because something had to be done within a period that has expired.

It is important to remember that the mistake must be one of the donor and must make it unconscionable for the done to retain the property. So if trustees transfer property to B as a result of a mistake and B suffers tax but the trustees do not, it may be difficult to obtain the relief.

This was the position in **Gresh v RBC Trust Co** [Guernsey 6/2016].

Mr Gresh was a member of a pension plan administered by a Guernsey trustee and had been advised that any lump sum distribution made to him would be tax-free provided that the distribution was not remitted to him in the UK. Mr Gresh requested a lump sum distribution. A transfer was made. The advice was wrong – capital payments were not tax free leaving Mr Gresh with a significant tax bill.

The payment was not set aside - it was not unconscionable for Mr Gresh to keep it - only Mr Gresh was adversely affected by the tax bill but he had received the money. There was no evidence that the tax bill would result in adverse consequences for anyone else.

Key considerations:

- What was the mistake?
- Was it a conscious mistake or an unconscious one?
- If an unconscious one was it a tacit assumption? (e.g. where client assumed that a deed would have no adverse tax consequences). What did the client assume about the consequences?
- Subjective evidence from S may be adduced. Is there any other evidence of a tacit assumption?
- What are the ramifications of the mistake for S? Are they sufficiently grave to secure rescission?
- If there are not direct ramifications for S, are there indirect ramifications for S? (e.g. Donee suffers tax charge and trustees feel obliged to make that good and so reduce trust fund for other beneficiaries.)

Procedure

- Should notify HMRC
- Generally application under Part 8
- Will need to lodge with evidence: this should set out all the evidence
- Need to have one Defendant at least. This will often be the donee(s).
- It may be necessary for all the beneficiaries of a trust to be represented – can the trustees represent all of them or do they require separate representation, do different classes require separate representation?
- Consideration may need to be given to representing minors and unborns.