Adams & Remers

A&R. Mistaken Rectification

Failure to Appreciate

Freedman v Freedman

Two properties were placed in trust for the benefit of the claimant. The claimant's father had originally loaned her money to purchase the first property (property 1). Later she wanted to move and buy another (property 2), but that move was blocked as she was unable to sell property 1. Her father then suggested he buy property 2 with the proviso that the money advanced was to be a loan, to be repaid on the eventual sale of property 1.

The claimant's father also suggested that the properties be put into a trust (with the aim of protecting the properties from any potential consequences of a relationship the claimant had). The trust was an interest in possession trust for the benefit of the claimant, with a power to appoint to a class of discretionary beneficiaries. The claimant had also entered into an agreement by which she would pay the loan on property 2 back to her father from the proceeds of sale of property 1.

Unfortunately the solicitor advising the claimant had failed to inform her of the negative effects of transferring the properties into a life interest trust by failing to realise that the transfer of assets into the trust would be a lifetime chargeable transfer for IHT purposes and (to the extent that the net value exceeded the nil rate band) there would be an immediate entry charge of 20% (s.49(1A) of the Inheritance Tax Act 1984 ("IHTA")) – in effect an entry charge. He also failed to realise that there would be a 10-yearly charge and exit charges (on appointing any funds out to her to enable her to discharge the loan). These charges seriously prejudiced the claimant's interests in particular her ability to repay the loan. On learning of the negative effects, the claimant sought to have the settlement set aside, on the grounds of equitable mistake. HMRC resisted the application.

The law of rescission of a non-contractual voluntary disposition was set out clearly by the Supreme Court in Pitt v. Holt, Futter v. Futter [2013] UKSC 26; [2013] 2 AC 108 and concisely summarised in Kennedy v. Kennedy [2014] EWHC 4129 (Ch):

1. There must be both a distinct and causative mistake as distinguished from mere ignorance or inadvertence (a "misprediction" relating to some possible future event). However, forgetfulness, inadvertence or ignorance can lead to a false belief or assumption which the court will recognise as a mistake.
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 and the court must make an evaluative judgment whether it would be unconscionable, or unjust, to leave the mistake uncorrected.
4. 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 Chancery Division held that, applying settled law, it was appropriate for the settlement to be set aside and reiterated the distinction between the Rule in Hastings-Bass (now much restricted and specific to trustee breaches of duty) and the law of mistake, which is of broader principle and application and does not require a breach of duty for its application (two separate but sometime overlapping strands of the law in this area).

The court found that a distinct and serious mistake had been made by the claimant as to the effect of the transaction – her ability to replay the loan - as opposed to a mistake of law or fact upon which the transfer was settled. Interestingly HMRC, in attempting to argue that the claimant's mistake was not sufficiently serious so as to vitiate the transaction tried to have 'their cake and eat it' and ran an argument that by contrast with the claimant's position a mistaken fiscal effect of a transaction (if fundamental to the purpose of the transaction) was a ground for granting relief by way of set-aside.

Out of the Frying Pan and Into the Fire

Vaughan-Jones v Vaughan-Jones

A post-death Deed of Variation is a well known tool for retrospective tax planning, so long as the Deed includes the necessary clear wording that it is intended by the parties to have retrospective effect.

This is a case where the solicitor-executor and beneficiaries entered into a Deed of Variation redirecting the residue of the estate to the deceased's spouse absolutely, the aim being to eliminate IHT (the deceased had made a gift of the residue of his estate in equal shares to his three children and his wife. This was IHT inefficient and gave rise to a substantial IHT liability on the children's shares).

The Deed however failed to incorporate the necessary statement that the parties were claiming retrospective tax treatment for inheritance tax purposes pursuant to s.142(1) of the Inheritance Tax Act 1984 (as required by s.142(2)). Accordingly, whilst the variation passed the entire estate to the deceased's spouse, the estate was still liable for IHT, effectively increasing the IHT liability from approximately £32,000 to approximately £232,000.

The court has a power to rectify an inter vivos instrument if (i) the document fails to give effect to the true intentions of the parties who entered into it; and (ii) where there is an issue capable of being contested between the parties – because their respective rights are affected by such an order. Rectification will not be ordered where the beneficiaries rights are unaffected and where the only effect of the order is to secure a fiscal benefit.

In this instance the intention of the parties was to secure a fiscal benefit (the IHT saving) but the Deed of Variation manifestly failed to give effect to their true intentions (the evidence being that the drafting solicitor had adopted an (apparently highly) out of date precedent, omitting the s.142 wording). The court found that the beneficiaries rights were affected – the estate was to be relieved of a substantial IHT liability affecting the surviving spouse's and the children's rights and the total of the transfers of value should any of the three children fail to survive for seven years from the Deed of Variation.

The court ruled that the Deed should be rectified to include the missing declaration that the parties claimed retrospective tax treatment.

Nonetheless, the family's fortunes were not restored. A Deed of Variation is ineffective for tax purposes where it is entered into in 'consideration for money or money's worth, other than consideration consisting in the making' (s.142(3) of the Inheritance Tax Act 1984). The evidence put forward in aid of the rectification claim was that the surviving spouse planned to transfer back to the children the tax-free money received by virtue of the Deed and HMRC had given notice that it considered the Deed was entered into for money's worth as part of a wider arrangement which fell foul of s.142(3). The battle now passes to the Beneficiaries v. HMRC.

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