THE BATTLE OF HASTINGS-BASS - THE TRUSTEE AND THE TAX ADVISER: WHOSE LIABILITY IS IT ANYWAY?

By Nikhil Mehta

1. Introduction

It is perhaps strange to say that a rule of trusts law provides a defence for tax advisers against being sued for professional negligence by trustee clients. As an exercise in lateral thinking, it might take some imagination to work out how this could be. But, at least until recently, that was thought to be the effect of what has been called "The Hastings-Bass principle". The principle owes its name to a 1974 decision of the Court of Appeal in *re Hastings-Bass Deceased* [1974] STC 211. There have been a number of cases since then in lower courts than the Court of Appeal, where the principle has been applied to various scenarios where the validity of exercise by trustees of their powers has been tested.

In March this year, the Court of Appeal had the opportunity to consider the principle again in two appeals which were heard together: *Pitt v. Holt* and *Futter v. Futter*. For reasons which will become clear, HM Revenue & Customs ("HMRC") were joined as co-defendants in both cases, and lodged appeals to the Court of Appeal against the decisions of the High Court.

The Court of Appeal allowed HMRC's appeals in both cases, and effectively rewrote the *Hastings-Bass* principle in a manner which has caused some consternation amongst tax advisers involved in trusts tax planning.

It should be emphasised that the two cases were not tax cases as such. They were to do with the validity of dispositions by trustees made ostensibly pursuant to the exercise of their discretionary powers, where tax was an important consideration in the exercise of the discretion. In each case, the trustees had taken professional advice on the tax implications and had proceeded after taking that advice into account: the advice turned out to be incorrect (and potentially negligent, although that itself was not decided in the appeals) with substantial adverse tax consequences. In those circumstances, how should the dispositions be treated in law and what should the tax consequences be? The *Hastings-Bass* principle held the key to the answers to these questions.

HMRC's primary concern was to know what the legal effect of the dispositions was so that they could apply the correct tax treatment. But since the *Hastings-Bass* principle would determine the outcome, HMRC had an interest in ensuring that its scope was properly defined by the Court of Appeal. This was the first opportunity since 1974 for the Court to review the principle in detail, including its application over the years by the lower courts.

Before considering what happened in the recent cases, I need to explain the background, beginning with the *Hastings-Bass* decision and the principle it is said to have established.

2. *Hastings-Bass*

Lord Justice Lloyd, who gave the leading judgment in *Pitt v. Holt*, summarised the facts in *Hastings-Bass* as follows:

> "In 1974 the Court of Appeal heard an appeal from an order of Plowman J in proceedings between the executors of the late Captain

> Peter Hastings-Bass and the Inland Revenue. The issue was whether estate duty was chargeable in respect of his death in 1964 on certain funds comprised in a settlement made in 1947 under which he had had a protected life interest. It held that the funds had been the subject of a valid advancement in 1958 under which a life interest subsisted in favour of his son William. It was valid even though the interests which had been intended to take effect subject to that life interest were void because of the application of the rule against perpetuities. It followed that this fund was not chargeable to estate duty on Captain Hastings-Bass' death. *Re Hastings-Bass deceased* is reported at [1975] Ch 25."

The case was concerned with the avoidance of United Kingdom estate duty, which was leviable on estates of deceased persons prior to capital transfer tax and inheritance tax. Captain Hastings-Bass held the life interest under a settlement made in 1947. Without any further planning, funds in the 1947 settlement would have been included in Captain Hastings-Bass' estate at the time of his death and taxed accordingly. The trustees of the 1947 settlement advanced funds in 1958 to another settlement created that year, in which his son, William, held a life interest, with the residuary estate held for the benefit of his children. Had that power of advancement been made successfully, the funds advanced would not have formed part of Captain Hastings-Bass' estate.

The validity of the advancement was thrown into doubt as a result of the House of Lords' decision in *Re Pilkington's Trusts* [1964] AC 612. The decision related to the rule against perpetuities. If the rule against perpetuities, as interpreted by the House of Lords, applied to the exercise of the trustees' power of advancement in 1958, then the advancement would be void. The funds subject to the 1958 advancement would have remained in the 1947 settlement. So, when Captain Hastings-Bass died in 1964, those funds would have formed part of his estate for estate duty purposes. The decision in *Re Pilkington's Trusts* was given after the 1958 advancement, but before the death of Captain Hastings-Bass.

The parties to the proceedings in *Hastings-Bass* were the executors of the estate and HMRC. There were numerous arguments advanced by each side. The fundamental point at issue was, however, a simple one: did the funds advanced in 1958 continue to remain in the 1947 settlement and therefore form part of Captain Hastings-Bass' estate; or was the estate duty saving successfully achieved by the 1958 advancement?

The Court found that the rule against perpetuities rendered void any advancement in favour of the residuary beneficiaries under the 1958 settlement. It did not, however, affect the advancement in favour of William, who held the life interest under that settlement. As a result, the exercise of the power of advancement by the trustees was valid, and the estate duty planning effective.

The trustees took professional advice in connection with the estate duty planning. While there was nothing to suggest that the tax advice was flawed, the dispute with HMRC arose in relation to the underlying trusts law in relation to the validity of the trustees' advancement of funds. HMRC attempted to persuade the Court of Appeal to ignore the advancement because the trustees' exercise of their power was fundamentally flawed. This attempt was unsuccessful.

3. What was the *Hastings-Bass* Principle before *Pitt v. Holt*?

The principle which evolved from this decision has been restated many times, both by the courts and by commentators, and not always consistently. Rather than attempt my own restatement, I would prefer to set out what Lord Justice Lloyd considered it to be, first before the *Pitt v. Holt* decision, and then in the decision itself. In his judgment in *Pitt v. Holt*, he candidly stated that his previous view of the principle was incorrect (as was the view of other judges in some of the previous case-law).

He gave his previous view a few years ago, when sitting as a judge in the High Court. In his judgment in *Sieff v. Fox* [2005] WLR 3811, he said:

> "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."

He went on to say that he did not think that the power of the courts to interfere was confined to situations where the trustees' purported exercise of discretion gave rise to a breach of duty by them, or a breach of professional duties by their advisers. He also confirmed that the fiscal implication of a proposed course of action was a relevant consideration for trustees to to take into account in deciding whether to proceed with it.

I will come to the *Pitt v. Holt* reformulation of the principle in Section 5.

As stated above, the *Hastings-Bass* case was a direct tax case involving a dispute with HMRC. The decisions since then, where the principle was applied in the context of private trusts, generally involved the conduct of trustees where tax was a significant factor. However, they related to issues such as the relationship between trustees and beneficiaries. They did not involve tax disputes with HMRC. HMRC were indirectly interested in the sense that they were required to apply the right tax treatment to the facts following the relevant decision under trusts law. If a disposition by trustees was set aside by the Court under the *Hastings-Bass* principle, HMRC would give effect to that. If the disposition was held to be effective, the tax consequences would similarly follow. Depending on the outcome, tax might be payable or refundable.

4. HMRC's View

In June 2006, partly in response to the decision in *Sieff v. Fox* referred to above, HMRC published their views of the *Hastings-Bass* principle and how they approached it in practice. By that stage, the application of the principle in matters where tax was relevant had generated great interest. Where such matters led to litigation, HMRC had a policy not to get involved in the proceedings but to await the outcome. Lloyd LJ had commented on this practice of non-interference in *Sieff v. Fox*, where he said it would be helpful to the Court in some instances for HMRC to join the proceedings.

That prompted HMRC to take action and to change their policy of non-intervention. *Pitt v. Holt* and *Futter v. Futter* are examples of that change in policy.

HMRC published their views in the June 2006 issue of the Tax Bulletin. They that considered the *Hastings-Bass* principle had become too wide in its scope in the thirty or so years since the original decision. It would, therefore, be in their interests to get involved in appropriate proceedings to "seek to influence the development of the principle in a particular direction". Some of the salient points they made were as follows:

- The principle in its present form had little or nothing to do with the type of situation which was considered by the Court of Appeal in *Hastings-Bass* itself; it had been developed in later case-law in an incorrect manner.

- The effect of the principle should be to make the relevant decision by the trustee voidable and not void, or at the very least should permit the court to take into account the same sort of equitable considerations that apply when it is deciding whether to grant other forms of equitable relief.

- The principle should as far as possible be assimilated with the general principles of law by reference to which (a) the exercise of discretion by trustees might be impugned and (b) the courts would set aside voluntary transactions or written instruments for mistake. On this basis, there might be no room or need for a separate *Hastings-Bass* principle at all.

- In cases where the trustee acted under a discretion and was not obliged to act, HMRC agreed with the view expressed by Lloyd LJ in *Sieff v Fox*, that the relevant test is whether the trustee "would" have acted differently if the correct considerations had been taken into account, not whether the trustee "might" have acted differently.

- While accepting that fiscal consequences were generally amongst the matters which a trustee should take into account when deciding how to act, HMRC felt a distinction needed to be drawn between cases where the trustee failed to take relevant fiscal considerations into account at all, and cases where the trustee took steps to obtain fiscal advice but that advice turned out (for whatever reason) to be wrong. While there may be scope for the principle to apply in cases of the former type, they felt that in cases of the latter type (including *Sieff v Fox*), the principle should not apply.

- Similarly, in cases where the trustee obtained advice about the tax consequences of a proposed transaction, but then failed to implement the transaction in accordance with that advice, the principle should not apply. A common feature of some of the cases was that the trustee had sought appropriate tax advice, and in reliance on it had deliberately taken certain steps which in trust terms achieved precisely the effect which they were intended to achieve. Why then should the trustee be entitled to have the transaction set aside, in a way that would not be open to an individual taxpayer, merely because the advice which he obtained was incorrect, or because he negligently failed to follow the advice correctly? In such cases, the court should not interfere, tax should be paid on the basis of the transaction actually carried out, and the trust should be left to pursue whatever remedies it might have against the trustee and/or the trustee's professional advisers.

- Finally, HMRC agreed with Lloyd LJ in *Sieff v Fox* that a breach of duty by the trustee or the trustee's agent or advisers was not in itself a separate requirement that had to be satisfied for the principle to apply.

It was clear that HMRC had by now become keen on persuading the Courts to review the *Hastings-Bass* principle. In practical terms, the sixth point above was particularly important. If trustees take tax advice which turns out to be wrong, why should the Court intervene to set aside the ensuing transaction? If the advice was negligent, the correct course of action for the trustees was to sue the advisers, not to ask the Court to "correct" the state of affairs as if the advice had not been followed.

It will be noted that if the principle offered protection to trustees who had taken negligent advice, it also operated as a defence for the advisers against a claim for professional negligence. If the Court set aside the relevant transaction, the tax consequences of the negligent advice would not crystallise so no claim could be sustained against the advisers.

5. The Reformulation of the Principle

Lloyd LJ gave a lengthy judgment in *Pitt v. Holt* with which the other two judges agreed. He considered the relevant case-law in great detail before expressing his view of what the *Hastings-Bass* principle really was. He distinguished between two different types of situations. The first type is where the action taken by the trustees is void because of a fundamental legal defect. *Hastings-Bass* itself was an example of this: the advancement made by the trustees was void because it breached the rule against perpetuities. The second type of situation was found in virtually every case since *Hastings-Bass*. This involved an exercise of discretion by the trustees within their powers. However, the exercise was potentially flawed because the trustees had failed in their duty to take into account all relevant matters, and not to take into account irrelevant matters.

He went on to say that, contrary to what he had said in his judgment in *Sieff v. Fox*, for the Court to intervene in the second type of situation, the action taken by the trustees had to constitute a breach of trust. That action was voidable, not void. In this type of situation, the Court could apply the principle to put aside the act carried out by the trustees. He doubted, therefore, whether the principle applied to the *Hastings-Bass* case itself, which involved the "void" situation. It took on a life of its own in subsequent cases and by a somewhat inappropriate process of association, became to be known as the *Hastings-Bass* principle.

In the context of professional advice taken by trustees where tax is relevant to the exercise of their powers, Lloyd LJ felt it was within the trustees' duty to exercise skill and care to take proper advice before acting. If they obtained such advice and took it into account when acting, they would discharge their duty of skill and care. As a result, their action would not give rise to a breach of trust even if the advice turned out to be wrong and the resulting action attracted unfortunate tax consequences.

The correct principle, as restated by Lloyd LJ, and in his own words, is as follows:

> "The cases which I am now considering concern acts which are within the powers of the trustees but are said to be vitiated by the failure of the trustees to take into account a relevant factor to which they should have had regard – usually tax consequences - or by their taking into account some irrelevant matter. It seems to me that the principled and correct approach to these cases is, first, that the trustees' act is not void, but that it may be voidable. It will be voidable if, and only if, it can be shown to have been done in breach of fiduciary duty on the part of the trustees. If it is voidable, then it may be capable of being set aside at the suit of a beneficiary, but this would be subject to equitable defences and to the court's discretion. The trustees' duty to take relevant matters into account is a fiduciary duty, so an act done as a result of a breach of that duty is voidable. Fiscal considerations will often be among the relevant matters which ought to be taken into account. However, if the

> trustees seek advice (in general or in specific terms) from apparently competent advisers as to the implications of the course they are considering taking, and follow the advice so obtained, then, in the absence of any other basis for a challenge, I would hold that the trustees are not in breach of their fiduciary duty for failure to have regard to relevant matters if the failure occurs because it turns out that the advice given to them was materially wrong. Accordingly, in such a case I would not regard the trustees' act, done in reliance on that advice, as being vitiated by the error and therefore voidable."

This reformulation of the principle narrows it in a number of ways:

- It has no application where an act is void, as opposed to voidable
- For it to apply, there must be a breach of trust committed by the trustees in carrying out the act
- Taking tax advice from competent professionals and acting on their advice will generally not involve a breach of trust where the advice turns out to be wrong
- If the act is voidable, it may be challenged by a beneficiary under the trust, but not by anyone else.

I deal with some of the implications for tax advisers in the last section of this article. Before that, it is necessary to consider how the Court of Appeal applied the principle in *Pitt v Holt* and in *Futter v Futter*.

6. The Decisions in *Pitt v Holt* and in *Futter v Futter*

Pitt v Holt involved an unfortunate set of facts. Mr Pitt had been involved in a car accident where he had suffered severe brain injuries. The management of his affairs had been given to his wife, who had been appointed as receiver by the Court. At the time when relevant professional advice had been taken, she was not a trustee, but the Court of Appeal stated that the *Hastings-Bass* principle was not confined to trustees, but was applicable to other fiduciaries such as receivers too.

Mrs Pitt had solicitors advising her in litigation proceedings against the other driver. The litigation was settled out of court with significant damages payable. On the recommendation of her solicitors, Mrs Pitt took specialist advice on how best to structure the settlement. For reasons which were not primarily tax driven, the specialist advisers recommended that the compensation should be put into a discretionary trust, under which Mr Pitt would be a beneficiary. Mrs Pitt became one of the trustees under the trust which was set up on the basis of this advice. While the specialists had pointed out certain income tax advantages in following this route, they had not taken into account the inheritance tax implications of setting up a discretionary trust. These were severe, because tax charges arose on the transfer of property into the trust. In addition, a periodic charge on each tenth anniversary would have arisen on the value of the property left in the trust, and finally, tax charges would arise on distributions made by the trustees out of trust funds. These charges would have significantly eroded the funds which were primarily required for Mr Pitt's care. Mr Pitt died in 2007.

What was particularly unfortunate was that, if the trust had been structured a little differently, it could have qualified for exemptions from all these charges under Section 89 of the Inheritance Tax Act 1984 (trusts for disabled persons).

The specialist advisers denied that inheritance tax was their responsibility. Proceedings against them for negligence had commenced but were stayed pending the outcome of the proceedings involving HMRC.

Applying the reformulated principle, the Court of Appeal held that Mrs Pitt had acted fully in accordance with her duties towards Mr Pitt in entering into the discretionary trust, having first taken expert advice. As a result, her actions as receiver were not voidable. The Court would not, therefore, interfere. The result was that the discretionary trust stood, and all the adverse inheritance tax consequences applied. HMRC's appeal was allowed.

An alternative ground in *Pitt v Holt* for setting aside the trust was based on the equitable doctrine of mistake. The Court held that this doctrine did not apply to Mrs Pitt's action, so HMRC's appeal was allowed on this point too.

Lloyd LJ acknowledged the unfortunate implications of the judgment for Mrs Pitt. However, he said her appropriate remedy was to sue the advisers for damages for negligence.

In *Futter v Futter*, the tax planning involved mitigation of capital gains tax arising in relation to certain transfers of assets to beneficiaries out of offshore trusts. It was thought that the tax charges could be mitigated by capital losses which were available to each beneficiary in a personal capacity. The tax advice was given by a well-known firm of solicitors. One of the partners happened to be a trustee of the trusts and was also involved in giving the tax advice.

Unfortunately, the advice overlooked Section 2(4) of the Taxation of Chargeable Gains Act 1992, which prohibited the use of losses in this way. The trustees followed the advice and the transactions went ahead. As a result, capital gains tax became payable.

So far as the relevant tax advice was concerned, it was clear that the advisers had been instructed to advise on capital gains tax, whereas in *Pitt v. Holt*, it was unclear whether the specialists were responsible for inheritance tax advice.

The Court of Appeal again found in favour of HMRC and allowed their appeal. Lloyd LJ said that the trustees had properly exercised their duty of skill and care in taking expert advice on capital gains tax planning and in following that advice. They had not committed any breach of trust. The fact that one of the trustees also wore a separate hat as adviser made no difference to his role as trustee. The trustees' actions were neither void nor voidable. The Court would not interfere with the trustees' actions under the *Hastings-Bass* principle. So, HMRC again succeeded in their appeal.

HMRC's success in both appeals vindicated their change of heart in 2006 about intervention in court proceedings. The Court of Appeal effectively agreed with most (but not all) of the views expressed by HMRC in 2006. If the decision stands, the likelihood of HMRC getting involved in similar proceedings will be much reduced since the scope of the *Hastings-Bass* principle has been sharply cut back.

7. Implications for Tax Advice

A curious anomaly of the Court of Appeal's decision is that a trustee who fails to take tax advice is in a different position to a trustee who has taken such advice. Lloyd LJ acknowledged as much in his judgment, but did not have any difficulty with this. The critical distinction is whether or not there has been a breach of trust. If there has, then the *Hastings-Bass* principle applies.

It may also be the case that a breach of trust could occur even where advice has been taken. The decision does not mean that the obtaining of advice precludes a breach of trust in all situations. For example, if the advice is given by someone who was not qualified to give it-and the trustees simply turned a blind eye to this when they could reasonably have been more vigilant, then arguably there could be a breach of trust. This gives rise to a startling possibility for the tax adviser: the greater the misfeasance of the tax adviser and the trustees' willingness to ignore it, the greater the chances of a breach of trust and of the transaction being set aside.

The facts in *Futter v Futter* raised the interesting question of what duty a trustee, who is also tax expert, has and whether it is any different to that of other trustees. Lloyd J suggested that role of trustee is different to that of tax adviser, so the tax expert/trustee has no greater duty of skill and care to beneficiaries even if involved in (effectively) advising himself. One can think of situations where this could be challenged. An example might be where the tax expert/trustee effectively has a dominant influence over the other trustees in arriving at a decision to take a course of action which is tax driven.

One of the difficulties with the old *Hastings-Bass* principle was its effect on different parties. If the trustees have done something wrong, then it seems strange that someone other than beneficiaries can benefit if their wrongful conduct is set aside. I am of course referring to negligent tax advisers. The Court of Appeal appears largely to have done way with this notion, except perhaps in the blatant disregard situation I referred to above. The logical conclusion is that tax advisers will be more vulnerable in proceedings for negligence. But it also needs to be kept in mind that there are a number of reasons why professional advice can turn out to be wrong, including a different view taken by a court in a future decision which affects the subject-matter of the advice. While the distinction between negligent advice and other wrong advice seems largely irrelevant to the question of a breach of trust, it will of course remain of great importance to advisers. This is particularly so in areas of trusts tax planning which HMRC perceive to be aggressive and which may become the subject-matter of litigation.

On 1st August, the Supreme Court granted permission to appeal in both cases. The battle is not yet over. The Supreme Court will have the last word on the subject.