

Rectification of trust deeds (Lecture P1268 – 10.14 minutes)

Background

Trusts may be created for tax or non-tax reasons (or both). Whatever the reasons, the tax implications of creating and running a trust need to be considered in advance.

The tax consequences of a trust may not necessarily be conclusive or clear from reading the trust deed. Clauses of the trust deed might be difficult to interpret, resulting in misapprehensions and mistakes about the tax treatment.

In practice, most settlors and trustees obtain tax advice before the trust commences, and on an ongoing basis. But even if tax advice has been obtained, it may not always be complete and correct; this could have unfortunate consequences in terms of unintended tax liabilities, etc.

The remedy of rectification

However, in some cases, it may be possible for the trust deed to be changed, so that the unintended tax consequences do not arise. This remedy is 'rectification', which requires Court approval.

HMRC will not necessarily oppose an application to have the trust deed rectified, but in any event the final decision rests with the Court.

The legal process of rectification was described in a Court of Appeal case *Allnutt v Wilding* [2007] EWCA Civ 412 (by Lord Justice Mummery):

"...rectification is about putting the record straight. In the case of a voluntary settlement, rectification involves bringing the trust document into line with the true intentions of the settlor as held by him at the date when he executed the document. This can be done by the court when, owing to a mistake in the drafting of the document, it fails to record the settlor's true intentions. The mistake may, for example, consist of leaving out words that were intended to be put into the document; or putting in words that were not intended to be in the document; or through a misunderstanding by those involved about the meanings of the words or expressions that were used in the document. Mistakes of this kind have the effect that the document, as executed, is not a true record of the settlor's intentions."

Ware v Ware

In the recent case *Ware v Ware* [2021] EWHC 694 (Ch), the claimant and defendant were the trustees of two will trusts. The trusts were created by a deed of variation in October 2005. In 2005 and 2013, deeds of appointment were executed by the trustees. The intention of the 2013 deeds of appointment was to add family members as trust beneficiaries. However, their effect (as well as adding further beneficiaries, as intended) was to terminate the claimant's interests in possession in trust funds and appoint new ones in their place.

Terminating the claimant's interests in possession in the fund also had significant adverse tax consequences:

1. The claimant would be deemed to have made an immediately chargeable transfer for IHT purposes, resulting in an IHT charge of 20% of the value of the underlying property over and above the claimant's available nil rate band.
2. The trust funds would be in the IHT relevant property regime, meaning that they were subject to 10 yearly charges and exit charges of up to 6%.
3. The claimant would have been treated as having made a gift with reservation of the underlying trust funds for IHT purposes while he retained an interest in them.
4. Even though the underlying trust funds were liable to IHT on the death of the claimant under the gift with reservation rules, there would be no CGT-free base cost uplift in the value of the underlying property on his death as there usually is where there is an IHT charge on death.

The claimant applied to the High Court for rectification of the 2013 deeds of appointment, on the grounds that the deeds mistakenly (and unnecessarily) included provisions which terminated the claimant's existing interests in possession and appointed new ones in their place, when they were only intended to add certain persons as additional default beneficiaries.

The High Court addressed the legal principles to be applied when considering the rectification of a document. One of these (which the Court cited from *RBC Trustees (CI) Ltd v Stubbs* [2017] EWHC 180 (Ch)) was:

“...there must be a flaw in the written document such that it does not give effect to the parties'/donor's agreement/intention, as opposed to the parties/donor merely being mistaken as to the consequences of what they have agreed/intended. *For example, it is not sufficient merely that the document fails to achieve the desired fiscal objective*” (emphasis added).

Fortunately, the evidence in *Ware v Ware* clearly showed that the trustees' intention was limited to adding relatives as additional beneficiaries to the classes in whose favour the trustees' powers of appointment might be exercised. To achieve that result, it was not necessary to terminate or replace the claimant's life interests, and there was no evidence that the trustees intended to do so. The Court therefore granted the order for rectification.

It's all about tax...

By contrast, in *Allnutt v Wilding*, the taxpayer wanted to reduce the IHT that would be payable on his death. He made a gift of £550,000 into a discretionary settlement in 1995, thinking that it would be a PET for IHT purposes. However, the gift was, in fact, an immediately chargeable lifetime transfer. The claimant sought to rectify the trust deed to make the trust interest in possession instead of discretionary, as a transfer of value into an interest in possession trust would have been a PET at that time.

Unfortunately, the Court of Appeal rejected the application for rectification. The settlement correctly recorded the settlor's intention at the time, which was to confer benefits on his three children. In that sense, there was no mistake; the fact that the taxpayer's fiscal purpose had not been achieved wasn't considered to be material.

Conclusion

The remedy of rectification is available to change a trust deed and its tax consequences, if the legal principles for rectification are met.

However, rectification should not be relied on as a solution. The application process can be expensive and unpredictable. Rectification should only really be considered as a remedy of last resort, and expert legal advice is essential.

Contributed by Mark McLaughlin