Mistakes and misconceptions

Deeds of variation are often misunderstood in practice. Charlotte Watts and Joshua Lewison discuss a case that highlights common misapprehensions and possible solutions

The mechanics of deeds of variation are not widely covered either in the cases or the textbooks. In practice, they can often give rise to problems because they are unintuitive and poorly understood. The recent case of *Donkey Sanctuary v Bacchus* [2020] highlighted the potential pitfalls for the unwary and the importance of ensuring that your deed does what you intend it to do.

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Facts of the case

Leonard Dunthorn and Ruby Watts were brother and sister. Leonard died first, on 1 March 2018. He left his residuary estate to Ruby with a gift over to ten charities if she predeceased him. Ruby died on 16 March 2019. She left her residuary estate to 11 charities, the same ten as Leonard plus the MS Society.

One of the charity beneficiaries suggested that Ruby's executors could execute a deed of variation to pass Leonard's residuary estate directly to the charities, thereby saving inheritance tax. Ruby's executors executed a deed. Unfortunately, however, the deed varied Ruby's interest in Leonard's estate to give it to the ten charities named in his will, not the 11 charities named in Ruby's will, because the solicitor drafting it incorrectly thought that it was only possible to give money from Leonard's estate to the beneficiaries named in his will. It thereby missed out the eleventh charity Ruby had wanted to benefit – MS Society – without that charity having consented to the deed.

As well as depriving MS Society of its legacy, there was a danger that the deed would not be valid for tax purposes. The 11 charities therefore tried to remedy the problem by asking the court to declare the deed void or set it aside, so that the executors could enter into a valid deed instead. The charities raised a number of potential arguments including:

- that the deed was void as it was not within the executors' powers to give away part of the MS Society's share of Ruby's estate (known as 'excessive execution'); and

- that the deed should be set aside as the executors had not properly considered the effect of the deed: in breach of their fiduciary duties, they had not taken proper advice (known as inadequate deliberation').

The executors, who also wanted to put things right, raised a further argument: that the deed should be set aside on the basis that the disposition to the ten charities under the deed was the

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result of such a significant mistake by the executors that it would be unconscionable to refuse relief.

Deeds of variation: the law

Confusion about deeds of variation seems most often to arise out of two elements of duality. The first is that deeds of variation have an effect as a matter of property law and, potentially, a separate effect as a matter of tax law. The second is that deeds of variation are often drafted as though they were true variations of the disposition of the estate, when in fact they are *inter vivos* dispositions made by the beneficiaries, in this case Ruby through her executors.

The rules governing the tax treatment of deeds of variation are set out in s142 of the Inheritance Tax Act 1984 (IHTA 1984). If a deed is executed in accordance with this section, then the variation will be treated as having been made by the testator for inheritance tax (and capital gains tax) purposes (ie it should be read back for tax purposes).

The requirements of s142 IHTA 1984, so far as relevant to this case, are as follows:

- the deed must be executed within two years of the testator's death;

- the deed must contain a statement 'by all relevant persons' that they intend the read back provisions to apply – in this case, the relevant persons were Ruby's executors, as they were varying her entitlement from Leonard's estate; and

- the executors must let the charities who benefit from the deed know about it.

Mistakes commonly arise, as in this case, about who the necessary parties are. It is not always clear who is giving up a gift and who is receiving it, especially since that may not

necessarily coincide with who benefits from the arrangement. There is also a perceived connection between effectiveness as a matter of property law and effectiveness as a matter of tax law. In fact, a deed of variation may be perfectly effective to make the dispositions, but ineffective to secure any change in the tax treatment. For example, a beneficiary might agree to give up a legacy in exchange for consideration passing outside the estate. The transfer of the legacy would be perfectly valid, but under s142(3) of IHTA 1984, external consideration would disqualify a variation from being treated as a disposition made by the deceased.

Deeds of variation are also surrounded by misconceptions. Chief among them is the myth that a deed of variation cannot be done at all after two years. It can, but it will not attract the favourable tax treatment. A second misconception is that the arrangement can only be made between the existing beneficiaries of the estate – as was erroneously thought in this case – and that the dispositions can only be those that the deceased could have made.

The law: rectifying the situation

In the cases of *Pitt v Holt* and *Futter v Futter*, which were heard together (*Futter v HMRCC* [2013]), the Supreme Court clarified the limited grounds on which the court can declare a trustee's (or executor's) decision void or set it aside.

Before *Pitt*, the rule in *Re Hastings-Bass* [1974] had previously been used to set aside trustees' decisions on the grounds of mistake where those decisions had resulted in unintended consequences (mainly from a tax point of view) whether or not the trustees had committed a breach of duty in making those decisions. However, the Supreme Court held that the decision in *Hastings-Bass* involved two categories of mistake:

- Where a trustee purports to do something which is outside the trustee's powers, it is void (excessive execution).

- Where a trustee purports to do something which is within their powers but which has unintended consequences *and they commit a breach of duty in making the decision*, it is potentially voidable (inadequate deliberation).

This significantly narrowed the application of the rule in *Hastings-Bass*. It is now only possible to set aside a decision if it resulted in unintended consequences *and* a trustee has committed a breach of duty. If, for example, a trustee took advice but that advice was wrong, *Hastings-Bass* could not be used; instead, the trustee would have to sue the adviser.

Where a deed falls foul of s142, merely missing out on a potential tax benefit may not be enough to engage the mistake jurisdiction. *Pitt* cast doubt on the distinction drawn in *Gibbon v Mitchell* [1990] between the effect of a decision and its consequences. *Gibbon* suggested that a decision could only be set aside if the trustees had made a mistake about the primary effect of it, rather than the potential consequences, whereas *Pitt* held that this was too narrow a test. However, setting aside a deed that successfully executes the intended dispositions just because it does not secure a tax advantage may be a tough sell with the court.

The decision

The claimants concentrated on showing that the execution of the original deed of variation by the executors was either the result of excessive execution or inadequate deliberation.

The court found in the charities' favour on three different grounds:

- By effectively giving away part of MS Society's share of Ruby's estate, the executors had acted outside of their powers and therefore the deed was void. The executors were bound to execute the terms of Ruby's will and did not have power to dispose of her estate other than in accordance with its terms without the beneficiaries' consent (excessive execution).

The judgment confirms that the personal representatives' power derives from the consent of the beneficiaries and not from any inherent ability to depart from the dispositions of the estate made by the deceased.

- The deed should be set aside on the basis that the executors had not considered the effect of the deed of variation on MS Society's entitlement owing to their breach of duty in failing to take proper advice (inadequate deliberation).

- The disposition under the deed to the ten charities was the result of such a fundamental mistake by the executors (ie their mistaken belief that they could not benefit MS Society under the deed) that it was unconscionable not to set it aside.

The court therefore applied the rules in *Hastings-Bass* and *Pitt*, as well as the law on mistake in relation to dispositions.

In doing so, the court injected some welcome clarity into this area of the law, in particular by the careful treatment of the distinction between the property law effects of a deed of variation and the tax law effects. It involved, in particular, an examination of the source of personal representatives' powers to enter into deeds of variation. It is widely assumed that personal representatives can do this (even in guidance from HMRC; see the IHT Manual at IHTM35042) but we were unable to locate any authority for such a power. The judgment confirms that the personal representatives' power derives from the consent of the beneficiaries and not from any inherent ability to depart from the dispositions of the estate made by the deceased.

Conclusion for practitioners

There is no doubting that the dispositions in this case were at the more mind-bending end of the spectrum, not least because of the number of charities involved. The individual elements were straightforward enough – redirecting gifts to charity so that they come out of the estate

of the first to die rather than a survivor's estate – but in combination (and with the added pressure of the two-year time limit for executing the deed) they might have got the better of any number of personal representatives. The moral of the story is that, if in doubt, take advice. This is a particularly technical area and the court may not always be so willing to allow a second attempt. ■

Donkey Sanctuary & ors v Bacchus & ors (2020) unreported, Deputy Master Smith, High Court of Justice, 24 February (to be reported in a future issue of *Wills and Trusts Law Reports*)

Futter v HMRCC (with Pitt v HMRCC) [2013] WTLR 977

Gibbon v Mitchell [1990] 1 WLR 1304

Re Hastings-Bass [1974] EWCA Civ 13