Tax avoidance schemes: the risk of being knowingly wrong

Personal tax Management of taxes

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We consider the limits of setting aside transactions on the ground of mistake in the context of artificial tax avoidance schemes.

Key Points

What is the issue?

The case *Bhaur v Equity First Trustees* considers the limits of the courts' powers when reversing transactions relating to trusts on the equitable ground of mistake.

What does it mean for me?

The decision to refuse the relief where the appellants knowingly entered into a complex tax avoidance arrangement, which then went wrong, makes it clear that the courts have little sympathy for these types of predicaments.

What can I take away?

Mistake cannot be a safety net when you knowingly run the risk of being wrong.

The recent Court of Appeal decision in *Bhaur and others v Equity First Trustees (Nevis) Limited and others* [2023] EWCA Civ 534 is the latest in a long line of cases considering the limits of the courts' powers when reversing transactions relating to trusts on the equitable ground of mistake. This unanimous decision to refuse the relief where the appellants knowingly entered into a complex tax avoidance arrangement, which then went wrong, makes it clear that the courts have little sympathy for these types of predicaments. Further, the more artificial the scheme, the less likely the relief is to apply, even where the outcome for the claimants is potentially financially devastating.

Background

The Bhaur family built a successful property development and rental business over several decades. In 2006, on the advice of Aston Court (a tax advisory business), Mr and Mrs Bhaur entered into an inheritance tax avoidance scheme, marketed to them as an ‘Asset Liberation Solution’. This was principally to avoid a charge to inheritance tax on the passing of the property portfolio, then held in the couple’s own names, to their sons.

Broadly, the scheme involved setting up an employee benefit trust, a type of trust which must only benefit employees and their families. In principle, an employee benefit trust can benefit from favourable inheritance tax treatment if certain conditions are met. One of these is that both the participators in the close company (here, Safe Investments UK), which disposes of assets to the employee benefit trust, and any persons connected with those participators, must be excluded from benefiting from the trust (save as to income payments).

The scheme relied on the view that once the participators (Mr and Mrs Bhaur) had died, then their children would no longer be considered ‘connected’ to them and thus in the future could benefit from the employee benefit trust assets free of inheritance tax. As such, family members were classed as employees under the scheme, albeit their ability to benefit from the trust was limited accordingly.

After a complex sequence of transactions, involving various offshore entities – which ultimately amounted to a transfer of the Bhaurs’ business assets from Safe Investments UK to a British Virgin Islands trust company, to be held on the trusts of the employee benefit trust – the trustees resolved to distribute £480,000 of income to members of the Bhaur family.

This proposed distribution, in 2017, appears to have been prompted by HMRC starting to investigate various tax schemes promoted by Aston Court. Naturally, the distribution was driven by the trust terms, by which the trust assets had to be applied for the benefit of employees. The relevant family members refused the distributions, as they did not require the funds and the distributions would attract significant tax charges.

Given this refusal, the trustees instead resolved to distribute the remaining trust funds to the default charitable beneficiary of the trust, the NSPCC. Unsurprisingly, the Bhaur family objected and applied to the court for the initial transfer of assets into trust by Safe Investments UK to be set aside on the equitable ground of mistake, thus hoping to effectively unravel the scheme and reclaim the trust assets.

By this stage, HMRC had also challenged the scheme directly, which, if successful, would lead to ‘seriously disadvantageous tax consequences’ for the Bhaur family, as well as the loss of any inheritance tax reliefs and potentially the wider family fortune via associated costs and penalties.

High Court judgment

Mr and Mrs Bhaur’s application was rejected by the High Court in 2021, primarily because the unintended consequences of the scheme did not amount to mistake, but mere misprediction as to the consequences of the scheme.

The High Court held that the test for mistake as set out in *Pitt v Holt* [2013] 2 AC 108 was not met. In brief, the test is that:

i. there is a genuine mistake of a relevant type (and not a mere misprediction: ‘a misprediction relates to some possible future event, whereas a legally significant mistake normally relates to some past or present matter of fact or law’); and

ii. the mistake is so serious that it would be unconscionable for the donee to retain the property given to them.

Grounds of appeal

The Bhaur family appealed on four closely related grounds. The three most important grounds considered by the Court of Appeal were that:

1. The appellants did not mispredict the tax consequences of the scheme failing, but rather they made a mistake of the relevant type when entering into the scheme because they thought there would not be 'ruinous' tax charges if the scheme failed.
2. The appellants were mistaken as to their belief in the honesty of Aston Court and relied upon this trust in Aston Court when entering into the transaction.
3. The appellants had a mistaken belief that they would still retain de facto control over the assets put into trust. Their mistake was that they ceded control to 'rogues' rather than trustworthy individuals.

Court of Appeal judgment

On the appellants' first ground, LJ Snowden noted that the distinction between misprediction and mistake can often be very fine, if not outright blurred. Indeed, he noted that the relevant transaction could reasonably be characterised as either: (i) Mr Bhaur making a judgment as to the future likelihood of the scheme succeeding and the potential consequences of failure being limited; or (ii) a mistake as to the legal nature of the transaction and the reversibility of it.

However, he ultimately held that the question of misprediction versus mistake was moot in this case, as relief should not be granted on equitable grounds in any event. This conclusion was specifically reached on the premise that the transaction failed to meet the second limb of the test in *Pitt v Holt*, that it would be unconscionable for the donee to retain the property.

In denying the relief, particular emphasis was placed on the fact that the scheme was entirely artificial (there were initially no non-family employees under the employee benefit trust and there was no reason to employ individuals other than to enable the scheme). Knowing this, the Bhaurs had made a deliberate decision to proceed, cognitive that there was 'a risk of failure and possible adverse consequences … in implementing the scheme Mr and Mrs Bhaur knew there was a risk and decided to take it anyway'. As such, it was not unjust to leave the mistake uncorrected.

On the appellants' second ground (that they were mistaken in their belief as to the honesty of Aston Court), LJ Snowden did not consider that to be the 'type of mistake which can possibly justify setting aside a gratuitous disposal in favour of a third party donee who has no knowledge of the dishonesty'. The mistake was not of a relevant type as it did not go to the root of the transaction; the Bhaurs' belief in Aston Court's honesty was *independent* of any particular transaction. Further, the judge expressed reticence in allowing the setting aside of gratuitous disposals because of negligence as a general policy position.

Third (on the ground regarding the level of control afforded to the Bhaur family), LJ Snowden questioned the relevance of this mistake on causal grounds. The mistake was not concerning the initial disposal by Safe Investments UK, but instead a mistake as to 'what would happen in practice in the future' (the allegation of 'rogue[ish]' behaviour being prompted by the events of 2017). Interestingly, the judge gave weight to the timing of the mistake when determining whether it was a mistake of the relevant type, expressing scepticism that the trustees exercising their powers in 2017 was capable of justifying the setting aside of the transaction ten years earlier.

Concluding points

This unanimous judgment gives further clarity to the position of the courts regarding the limits of the doctrine of mistake and its application in the case of artificial tax avoidance arrangements. While the court is generally willing to set aside transactions on the ground of mistake (even when the main issue concerns the tax implications of the transaction; for example, in the recent case of *Hopes v Burton* [2022] EWHC 2770 (Ch), where a mistake was made as to the 'vanilla' tax consequences of an event), the artificiality of the relevant tax mitigation arrangements is central to whether equitable relief may be granted.

As LJ Snowden stated: 'I fully accept that tax avoidance is not unlawful, but I agree with Lord Walker's observations in *Pitt v Holt* … that artificial tax avoidance is a social evil that puts an unfair burden on the shoulders of those who do not adopt such measures. In my view this is a weighty factor against the grant of any relief.'

Equally damning is entering into such arrangements with your eyes open (even if you cannot foresee the exact outcome): mistake cannot be a safety net when you knowingly run the risk of being wrong.