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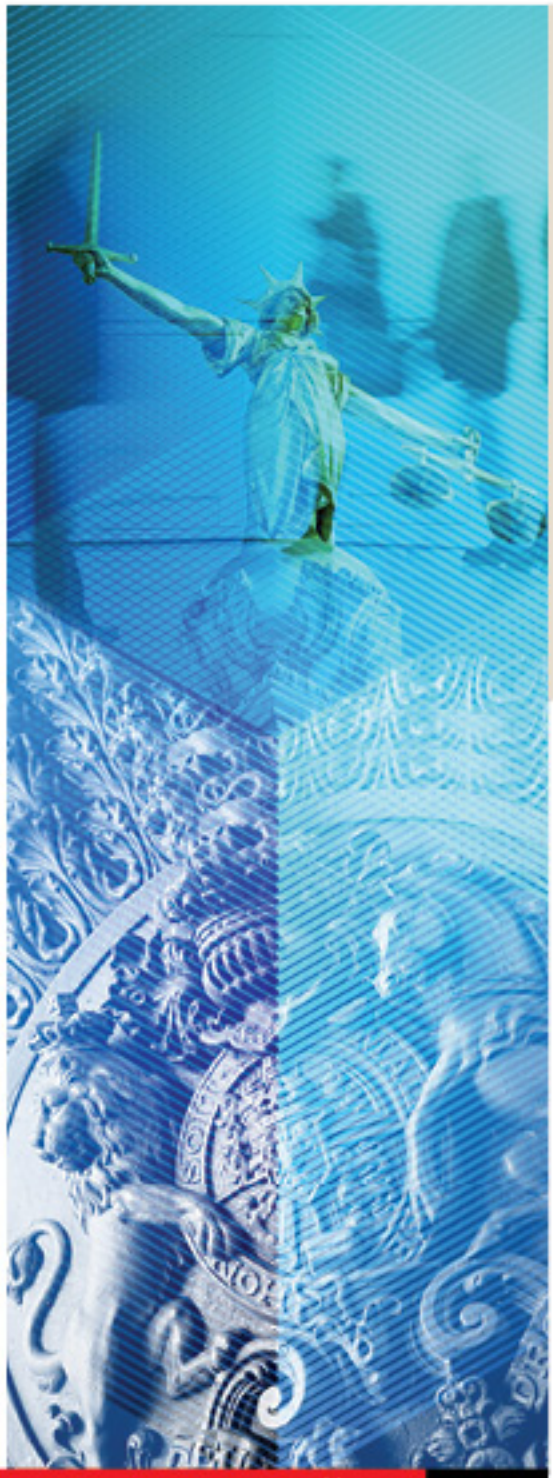

Rectification in a tax context

Are the courts taking an increasingly accommodating approach?

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Analysis

If I could turn back time: encouragement for taxpayers seeking rectification

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Cases such as *Racal* and *Allnutt* ostensibly laid down challenges for taxpayers seeking to rectify transactions entered into to achieve tax advantages. In particular, it has sometimes been said that rectification would not be available where a document had failed to obtain a tax advantage or if the only effect of rectification might be to secure a tax benefit. However, more recent case law demonstrates that the law is not so severe: the courts are adopting an increasingly accommodating approach where rectification is sought for tax purposes and have demonstrated a willingness to save taxpayers from mistakes.

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The equitable remedy of rectification on the grounds of mistake is an indispensable one in the field of tax. Where a document had been entered into which fails to achieve the tax outcome desired, advisers should always consider rectification and/or rescission. These remedies are available as part of the High Court's equitable jurisdiction to relieve parties of the unintended consequences of their mistakes, including fiscal consequences.

Taxpayers will primarily want to consider whether to make an application to the court under CPR Part 8. However, the decision of the Supreme Court in *National Union of Rail, Maritime and Transport Workers and another v Tyne and Wear* [2024] UKSC 37 (*RMT*) (on appeal from the Employment Tribunal) appears to support the argument that, where the conditions for rectifying a document are met, in proceedings before a statutory tribunal the document may be treated as rectified without any formal order for rectification being sought or obtained – per Lord Leggatt and Lady Simler (at [82]):

> 'Where the conditions for rectifying a document are met, the document may be treated for the purpose of determining the parties' legal rights as rectified without a formal order for rectification. There is no reason why this principle should not apply in proceedings in an employment tribunal.'

The judgment appears to confirm the Upper Tribunal's decision in *Lobler* [2015] UKUT 152 (TCC) stating that, if rectification would be granted by the High Court, a taxpayer's tax position is to be determined as if such remedy had been granted. HMRC have previously sought to argue (without success) that this approach is wrong and an application to the High Court remains necessary (see *Fashion on the Block Ltd* [2021] UKFTT 306 (TC)). The position in relation to other equitable remedies, in particular rescission, is less clear – see the contrasting FTT decisions in *Hymanson* [2018] UKFTT 667 (TC) and *Lefort* [2024] UKFTT 926 (TC), albeit in neither case did the FTT have the benefit of the Supreme Court's decision in *RMT*.

The upshot is that taxpayers can consider advancing rectification arguments not only in Part 8 claims before the High Court but also in proceedings before the FTT. As HMRC should now accept that taxpayers' legal rights fall to be considered subject to the principles of rectification (even absent any formal order from the High Court), it is open to taxpayers to advance such arguments in the course of enquiries and investigations, and it seems entirely in accordance with HMRC's Litigation and Settlement Strategy to consider those arguments (albeit HMRC's *Trusts, Settlements and Estates Manual* (at TSEM1902) still states that: 'In the absence of a court order, we would normally adhere to the tax consequences that flow from the actual words in the document'). Familiarisation with the relevant principles is therefore essential for all tax advisers and representatives.

The equitable remedy of rectification on the grounds of mistake is an indispensable one in the field of tax

Where a taxpayer does make a formal application for rectification to the High Court, HMRC will often adopt a neutral position but require the taxpayer to bring to the court's attention the two cases of *Racal Group v Ashmore* [1995] STC 1151 and *Allnutt v Wilding* [2007] EWCA Civ 412. In both cases, the claim failed because the taxpayer was unable to prove that the words in the instrument were different from those which were intended. It is sometimes said that the effect of those cases is that rectification is not available where a document has failed to obtain a tax advantage or if the only effect of rectification would be to secure a tax benefit. However, as more recent case law shows, the law is not nearly so severe, and rectification remains a vital remedy available to taxpayers where a mistake had led to the crystallisation of unintended tax liabilities.

Fundamentals

In general, there are four conditions that must be satisfied before a court will grant rectification of a written instrument – as summarised in *Giles v RNIB* [2014] EWHC 1373 (Ch):

1. There is clear evidence to demonstrate that the true intention of the maker of the instrument is not that expressed in the document.
2. There is a flaw (or operative mistake) in the document so that it does not represent the maker's true intentions.
3. The true subjective intention of the instrument's maker can be shown; and
4. There must be an issue capable of being contested between the parties.

There is considerable overlap in the first three conditions (referred to herein as the 'Intention Conditions'): essentially

it must be evidenced that there is a difference between (i) the intention of the person making the instrument and (ii) the content and/or effect of the instrument itself. Whilst not strictly a requirement, in practice some form of outward expression of the instrument maker's intention is likely to be necessary; see *Day v Day* [2013] EWCA Civ 280, per Lewison LJ at [22]:

> 'Although ... there is no legal requirement of an outward expression or objective communication of the settlor's intention in such a case, it will plainly be difficult as a matter of evidence to discharge the burden of proving that there was a mistake in the absence of an outward expression of intention.'

However, specific challenges arise in cases where the taxpayer seeks to obtain a tax benefit and various categories of intention can be envisaged:

- The parties may have a precise intention as to the transaction they are entering but the document does not reflect that intention – for example if, through clerical error, the document identifies the wrong assets to be settled.
- In other cases, a taxpayer may intend a particular transaction or type of settlement but be unaware or mistaken as to the tax consequences.
- In some cases, the taxpayer may intend to achieve a specific tax objective but, through error by the adviser, the document does not in fact achieve that objective.

The fourth condition identified in *Giles*, that there must be an issue capable of being contested (referred to herein as the 'Contestable Issue Condition') also gives rise to difficulties if the primary objective of the transaction and/or the invocation of rectification is not to change the substantive legal relations between the parties but instead to obtain a fiscal advantage.

Racal and *Allnutt*

Racal confirmed the Contestable Issue Condition stating that, in order for rectification to be granted, there must be an issue capable of being contested and not merely a fiscal benefit to rectification. Per Vinelott J (as approved by the Court of Appeal) at 1157:

> '[T]he court will make an order for the rectification of a document if satisfied that it does not give effect to the true agreement or arrangement between the parties … and if satisfied that there is an issue, capable of being contested, between the parties ... On the other hand, the court will not order rectification of a document as between the parties ... if their rights will be unaffected and if the only effect of the order will be to secure a fiscal benefit.'

In *Racal*, the donor covenanted to make four donations to a charitable trust which would have been eligible for tax relief had the dates specified for payment been spread out over more than three years; however, through oversight, the date specified for the final payment (1 April 1991) was within three years. As originally drafted, the deed drawn up by the solicitor had provided that the last payment was to be made on 1 April 1992 but, following a query from the company in relation to the last payment date, in the executed deed it was changed to 1 April 1991.

The High Court concluded that the claim for rectification must fail, firstly because there was no contestable issue between the parties outside a fiscal benefit (specifically, the right to treat the gross amount of annual payments as charges on its income), and secondly because taxpayer had not established to the necessary standard that the covenant did not give effect to its intention.

As to the first ground, the Court of Appeal observed that the deed provided the charitable trust with a claim against the donor for wrongful deduction of tax from the donation, which *was* a sufficient issue for the court to entertain the claim, notwithstanding that the application was essentially tax motivated (per Peter Gibson LJ at [1158]): 'Of course the fiscal advantages … lead it to seek rectification, but its desire to obtain those advantages … is immaterial if there is an issue capable of being contested between [the donor] and the trust.'

As to the second ground, the Court of Appeal, agreeing with the High Court, held that it was necessary not only to identify the tax benefit sought but specifically how that objective was to be realised: 'The specific intention of the grantor as to how the objective was to be achieved must be shown if the court is to order rectification.' The court took a strict approach to the Intention Conditions: notwithstanding that 'the evident purpose was to create a deductible charge', and that the minimum requirement for obtaining the relief was that the payments be made over more than three years, the evidence showed that the taxpayer company had requested that the particular date be specified as the final date of payment and therefore the deed of covenant was drafted as directed by the maker. Peter Gibson LJ therefore concluded (seemingly reluctantly): 'the court cannot rectify a document in the absence of evidence establishing those facts merely on the ground that the document has failed to achieve a desired fiscal objective.'

The demonstrable willingness of the courts to assist taxpayers grappling with ineffective documents and facing unintended liabilities is highly encouraging

The court adopted a similar approach in *Allnutt*: the settlor sought to achieve an inheritance tax saving on his death by establishing a settlement for his children and making a disposition which he mistakenly believed would be a potentially exempt transfer (PET). A PET could only have been achieved at that time by creating a settlement conferring interests in possession (IIPs). In fact, the trust was a discretionary trust creating no IIPs; therefore, the transfer was immediately chargeable to inheritance tax. The High Court and the Court of Appeal refused rectification on the grounds that the settlor had in fact intended to execute the settlement that he executed and therefore there was no relevant mistake save as to the tax consequences of the transactions (per Mummery LJ at [19]–[20]):

> 'The mistake of the settlor and his advisers was in believing that the nature of the trusts declared in the settlement for the three children created a situation in which the subsequent transfer of funds by him to the trustees would qualify as a PET and could, if he survived long enough, result in the saving of inheritance tax.
>
> 'That sort of mistake about the potential fiscal effects of a payment following the execution of the settlement does not, in my judgment, satisfy the necessary conditions for grant of rectification. The mistake did not result in the incorrect recording of his intentions.'

To summarise the cases that HMRC typically require to be placed before the court in an application for rectification:

- *Racal* confirmed that the Contestable Issue Condition requires that there must be an issue capable of being contested between the parties, and expressly held that

rectification would not be granted 'if their rights will be unaffected and if the only effect of the order will be to secure a fiscal benefit'.

- *Racal* and *Allnutt* appeared to hold that, in order to meet the Intention Conditions, a mistake as to the intended tax consequences of an instrument is neither necessary nor sufficient and the applicant must demonstrate that that instrument's maker had a specific intention in relation to the nature of the transaction which was not reflected by the document.

Wrong subject matter

The conditions for rectification were considered in *Giles v RNIB* [2014] EWHC 1373 (Ch). In that case, H had left a property and her residuary estate to E. H died and E died 18 months later leaving her residuary estate to various charities. The consequence was that H's estate was liable to inheritance tax. A deed of variation was attempted in order to divert H's estate to the charities directly (i.e. E's executor agreed to relinquish her interest under H's will) so as to achieve the inheritance tax saving for H. However, the deed was mis-drafted and had the effect of redirecting only the deceased's residuary estate, as opposed to the deceased's entire estate (as intended), to various named charities – in other words, it had identified the wrong subject-matter.

Notwithstanding that the purpose of the deed was to save inheritance tax, rectification was granted because the applicant was able to prove that the specific intention of the administratrix was to redirect H's entire estate to E. The court referred to *Swainland Builders Ltd v Freehold Properties Ltd* [2002] EWCA Civ 560 and observed that rectification was possible notwithstanding that there may have been more than one possible form of words for effecting the maker's intention in the deed of variation (per Barling J): 'the courts appear to have taken a relatively relaxed approach to the precise terms in which that effect was to be achieved in the instrument'.

In contrast to the facts in each of *Racal* and *Allnutt*, in *Giles* the applicant was able to evidence the maker's specific intention as to the content of the deed and that the deed, in failing to record all of the intended subject-matter, had been drafted by the professional draftsman in a way materially different from that intention (for another example of the content of a deed not enacting the maker's intentions, see *Morrell v Morrell* [2021] EWHC 117 (Ch)).

However, the approach to the Contestable Issue Condition in *Giles* does appear to constitute a relaxation of *Racal*, and in fact the court observed that that the content and scope of that condition were by no means clear and had been 'much criticised'. The particular facts of *Giles* were that, regardless of the deed of variation, the charities were entitled to the assets in questions (whether from H's estate or E's estate) and the court observed that the only party adversely affected by the proposed rectification was HMRC. However, the court appears to have accepted the argument that there was a contestable issue arising both as to which document gave rise to the charities' entitlements, and also from a potential negligence claim intimated by the charities against the executor and/or her solicitors.

In practice, the reliance on the potential negligence claim appears an important relaxation of the Contestable Issue Condition. Firstly, cases concerning rectification necessarily involve a mistake as to the implementation of instrument maker's intention so that, where lawyers have assisted in the drafting, there will often be a potential claim in negligence. Secondly, the court in *Giles* formed no view as the merits of the potential claim or how seriously it was being pursued; the claim had merely been 'intimated' in a letter by the charities to the solicitors.

Mistaken re-appointments

In *RBC Trustees v Stubbs* [2017] EWHC 180 (Ch) the trustees of a family settlement executed a deed revoking various beneficiaries' pre-2006 IIPs and reappointed new, identical IIPs for some of those beneficiaries. There was no difference in the substantive rights enjoyed by the beneficiaries under these new IIPs compared to the pre-existing ones, but in tax terms the termination of their existing IIPs brought the trust property within the relevant property regime (and caused deemed chargeable transfers to be made for IHT purposes).

On the evidence, the court accepted that the intention of the trustees had only been to revoke some of the beneficiaries interests, and that was sufficiently specific to meet the Intention Conditions. The court considered the argument against rectification that the trustees must have intended the revocation of the IIPs because 'the true effect of the document is very clear on the face of the Deeds themselves. This is not a claim relating to some obscure sub-clause hidden away in a long document'. But, whilst acknowledging that there was 'some force' in this point, 'it is also true to say that the Deeds are drafted in technical language. What was happening may jump off the page for an experienced trust lawyer, but it would not be apparent to a lay person, even one who was a trustee of the settlement'. The court was satisfied that that no instructions had been given to revoke the old IIPs.

At first sight, this might seem to be a more generous result than that warranted by *Racal*: if a distinction is to be identified it is that, in *Racal*, the maker of the instrument insisted on the words which resulted in the adverse tax treatment (that the final payment should be on 1 April 1991) being included in the instrument, and the date for payment was a matter comprehensible to a non-professional; by contrast, in *RBC Trustees*, there was no instruction that the original interests should be removed and the mistake was of a more technical nature.

The court distinguished *Allnutt* on the grounds that, notwithstanding that the meaning and effect of the deeds were clear, they did not accord with the evidenced intention of the trustees, which was limited to the removal of certain beneficiaries, and not the removal and reappointment of others, which could be identified separately from the tax implications (per Rose J at [58]):

> 'Here the mistake is not just about the fiscal consequences of what the Deeds achieved but about the scope of the changes ... that would be made ... the need for rectification can be made out here without having to refer to the tax consequences of the mistake. The mistake in the sense of a mismatch between the trustees' intention and the effect of the Deeds exists independently of the fiscal consequences even though the motivation in seeking the remedy from the court is based on those consequences. That was not the case in *Allnutt*; there the mistake could only be explained by reference to the tax consequences of the arrangement that the parties had intended to make and had in fact made.'

In relation to the Contestable Issue Condition, the court was satisfied that there were two contestable issues turning on whether the siblings' IIPs subsisted under the pre-2006 instruments or arose from the 2008 and 2014 deeds: first, the future IHT treatment of the trust property, and secondly, the treatment of the trust income

for apportionment purposes in the light of the Trusts (Capital and Income Act) 2013 s 1 of which abolished the statutory rules for apportionment for trusts created after 1 October 2013.

The approach in *RBC Trustees* was applied to similar circumstances in *Ware v Ware* [2021] EWHC 694 (Ch), a case that also involved an inadvertent revocation and reappointment of IIPs where the only persons prejudiced by the relief sought would be HMRC. The court accepted that the actual intention had only been to add new beneficiaries (not to terminate and re-appoint interests) such that there was a mistake in the relevant documentation, unlike in *Racal* and *Allnutt* where the relevant mistake merely concerned fiscal consequences. The court also accepted that there existed a contestable issue on the grounds that *RBC Trustees* had confirmed that a change to the date of a governing document was an issue of a kind being referred to in *Racal*.

Invalid deeds of variation

Wills v Gibbs [2007] EWHC 3361 (Ch) and *Vaughan-Jones v Vaughan-Jones* [2015] EWHC 1086 (Ch) concerned attempted deeds of variation which were ineffective for tax purposes because the solicitor had omitted to include the statements required by IHTA 1984 s 142(2) and TCGA 1992 s 62(7) that those provisions are intended to apply. It was accepted that the maker of such a deed would not have appreciated these legislative requirements and therefore would not have had any intention in relation to the necessary formalities to achieve the desired tax consequences.

However, in each case it was held that there was an intention to effect a valid deed of variation for the (sole) purpose of saving tax. By failing to include the statements required by the legislation, the relevant mistake was in failing to give effect to the machinery for achieving that outcome. Rather than following *Racal* and *Allnutt*, in *Wills* Rimer J preferred to apply *Jervis v Howle and Talke Colliery Co Ltd* [1937] 1 Ch 67 as a guide. Whilst intention as to obtaining a tax objective was considered sufficient to meet the Intention Conditions, the court required such intention to be tax-specific and, for this reason, in *Vaughn-Jones*, the court held that the requirements as to intention were only met in relation to IHT because the attendance notes referred only to that tax and not to CGT.

In both cases, the court referred to *Racal* as authority for the proposition there must be a real issue between the parties, but appeared to hold that the condition was satisfied merely due to the substantial sums of inheritance tax in issue, albeit the court also referred to consequential matters including whose estate might be liable for that tax, the cumulative total of transfers of value, and the need to wait for the expiry of a seven year period before making further dispositions. It was not suggested that there needed to be any issues which did not relate to tax liabilities or the direct consequences of those liabilities, and no non-fiscal issues were relied upon by the court in either case.

Wrong number of shares

In *Prowting 1968 Trustee One Ltd v Amos-Yeo* [2015] EWHC 2480 (Ch), an insufficient number of shares had been transferred to meet the conditions for Entrepreneurs' Relief. In relation to the Intention Conditions, the court drew a distinction between:

- a mistake as to the effect of a document; and
- a misapprehension of what the fiscal or other consequences are of a document which does not in fact mis-implement the parties' or donor's intention.

The court acknowledged that the distinction would not always be clear cut. Nonetheless, having considered *Vaughan-Jones*, the court accepted that the intended effect of a document could be identified in terms of its tax objectives and the mistake could be the failure to implement those objectives (whereas in *Allnutt* the mistake had related solely to fiscal consequences). Adopting that approach, the court found that the parties' intention had been for the purchasers to receive enough shares to satisfy the requirements for Entrepreneurs' Relief. The fact that the parties had left the precise number of shares to be determined by their advisors did not prevent such intention from being sufficiently specific, nor did the fact that the parties had yet to agree the actual number of shares that they would transfer.

Cooke [2024] UKFTT 272 (TC) concerned similar circumstances, albeit rectification was being considered in a statutory appeal. The taxpayer had purchased 4.99998% of the ordinary share capital rather than the 5% required for Entrepreneurs' Relief. The FTT found that the intention had been to transfer a minimum of 5% to qualify for relief. This intention consisting of the obtaining of a tax relief was sufficient and any lack of precision around the exact number of shares purchased was addressed by the principle that the exact form of words was immaterial. The FTT also acknowledged that it was difficult to read cases such as *Lobler* and *Prowting* as involving anything other than a purely fiscal benefit.

Considering the trajectory of the more recent case law, not only have the majority of applications for rectification succeeded, but it further appears that the requirements for rectification may have been eased for transactions with tax objectives

Relaxed requirements for rectification?

Considering the trajectory of the more recent case law, not only have the majority of applications for rectification succeeded, but it further appears that the requirements for rectification may have been eased for transactions with tax objectives.

The Contestable Issue Condition has been doubted and was arguably eliminated entirely in cases such as *Wills* and *Vaughan-Jones* where the only issues identified appear to relate to tax liabilities and other consequences arising from the tax treatment of the transactions. In this regard, the case law may be mirroring developments in the law of rescission, in particular in *Pitt v Holt* [2013] UKSC 2 which does away with a Contestable Issue Condition in the rescission context (though this point is not beyond doubt; see *Henderson v Garnett* [2024] EWHC 3128 (Ch) at [74]–[76]). Even in cases where the court has maintained that the contestable issue must be non-fiscal in nature and more than theoretical, the court has accepted that any changes in substantive rights, or even identical rights arising from a different document, are sufficient to meet the condition, and has also been willing to accept a potential claim in negligence against the advisor as satisfying this condition. Applying this approach, the condition should be capable of being met in the vast majority of cases.

In relation to the Intention Conditions, whilst the courts maintain that the applicant must furnish evidence of

their specific intention rather than appeal generally to their (tax) motive, the court accepts that, where a transaction has been undertaken in order to obtain a particular fiscal objective (for example, meeting the requirements of a provision or relief), the donor's intention is sufficiently specific such that where the document executed does not achieve that objective that will constitute a mistake capable of being rectified. This is notwithstanding that the parties understand the actual terms of the documents and it is only fiscal intentions that are not fulfilled.

The fact that the transactions may have been intended to achieve a tax advantage is certainly not fatal to any claim for rectification. In fact, in *MV Promotions Ltd v Telegraph Media Group Ltd* [2020] EWHC 1357 (Ch), the *lack of* fiscal motivation at the time of the transaction prevented rectification since the parties could not be said to have intended to avoid the unfavourable tax consequences which followed.

It can be speculated whether the applicants in *Racal* and *Allnutt* would be granted relief by the court if those cases were heard today. In *Racal*, the taxpayer's intention was to obtain a particular tax treatment, namely that the payments be deductible, and that intention was not realised because the date of the final payment was specified too early. That is ostensibly analogous to *Prowting* and *Cooke* in which the taxpayers sought a shareholding that would be subject to Entrepreneurs' Relief, yet the court felt able to treat the number of shares as increased to the minimum necessary to satisfy the legislative requirements. By the same token, a court could rectify an instrument similar to that in *Racal* to ensure that the tax objective is satisfied by providing that the final payment be made following the expiry of the three-year period. However, it appears that the ultimate problem in *Racal* was evidential: unfortunately, it had been the taxpayer's own intervention that led to the selection of the date for the final payment, such that it was impossible to characterise the selection of that date as a mistake.

Allnutt is arguably a more challenging case to reconcile with the recent case law. Where a taxpayer has the specific intention of making a PET in order to save IHT, that tax objective appears similar in nature to those in cases where the aim was to obtain an inheritance tax or CGT benefit pursuant to a deed of variation or share purchase agreement. In those cases (and subject always to adducing the necessary evidence), the intention to obtain a tax advantage could meet the Intention Conditions and a relevant mistake would occur if an advisor failed to implement that intention through the documentation (as appears to have occurred in *Allnut*).

Overall, the demonstrable willingness of the courts to assist taxpayers grappling with ineffective documents and facing unintended tax liabilities is highly encouraging and, coupled with the Supreme Court's apparent confirmation that formal orders for rectification are not necessarily required, taxpayers and advisers should be confident in relying on rectification as a potential means of resolving disputes with HMRC. ■

A second article by the authors considering the legal and practical aspects of rescission will be published soon.

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