THE LIMITS OF RECTIFICATION

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1 Introduction

Sometimes, in tax planning, things go wrong. The basic planning may be misconceived. Or the basic strategy may be fine but some point of detail may have been overlooked in the implementation. In yet other cases, both the strategy and the implementation may have been sound yet the law may be changed retrospectively. This can happen by the courts interpreting a statute in a way in which it would not have occurred to any man of intelligence, learned in the law and acquainted with the English language that it could possibly be interpreted. See for example *MacDonald (Inspector of Taxes) v Dextra Accessories Ltd and others* [2005] UKHL 47 [2005] STC 1111. Or the government may have brazenly pretended that there is no retrospectivity. See, for example, Finance Bill 2008 clause 55 UK (Residents and foreign partnerships).

While it is not always possible to work miracles so as to change the past, the tax specialist who is not also a Chancery lawyer might be pleasantly surprised to discover surprising how often things can be set right by the application of Equitable (and, less often, Common Law) doctrines.

In this article, I consider one such Equitable doctrine, the remedy of rectification, and consider its limits, as emphasised in a recent decision of the Court of Appeal.

2 The Nature of Rectification

Rectification is an Equitable remedy which enables mistakes in written instruments incorporating legal agreements and other legal transactions to be corrected with retrospective effect to the time of the written instrument.

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Broadly speaking, it is available where the parties[2] executed the instrument in ignorance as to its contents and in the mistaken belief that its contents were different from what they actually were. The Court of Equity rectifies or amends the instrument by making appropriate corrections to make it accord with the intention of the parties. It further prevents either of the parties from claiming in any other proceedings that the amendments were not made prior to execution.

In a tax context, it appears to be generally accepted (rightly, in my view) that rectification binds also Her Majesty's Commissioners for Revenue and Customs. Thus, rectification can in principle alter tax consequences retrospectively.

The remedy is not available simply because the parties executed the written instrument under some other mistake. Mistake *can* have an operative effect outside the law of rectification. However, the consequence of such mistakes is either to make the transaction void *ab initio* (which is not in point here) or to give one or both parties the right to elect to set the transaction aside. In some contexts, setting aside a transaction, so that the parties can start again, may be all that is required. In other cases, however, it is not enough that, in effect, *nothing* happened in the past. It is vital to be able to show that something *different* happened. That is where rectification can be extremely useful.

3 The Court of Appeal Decision in *Allnutt v Wilding*

3.1 The Case in Outline

The law relating to the availability of rectification has been conveniently re-stated in a recent decision of the Court of Appeal, *Allnutt v Wilding* [2007] EWCA Civ 412, delivered on April 3rd 2007. The parties entered into the wrong transaction (a gift in settlement on discretionary trusts) as a result of a misapprehension as to the tax consequences. While the remedy of rectification was sought, it was refused. While it might have been possible to set aside the original transaction, that would not have produced the desired tax consequence.

3.2 The Facts

Lord Justice Mummery gave the lead decision.[3] He summarised the facts:

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2 It is probable that in the case of a voluntary instrument, such as a settlement or a deed of gift, it is the intention only of the settlor or donor (and not of e.g. the original trustees) which is relevant, unless rectification would prejudice another party who was not a volunteer e.g. the trustees if the rectification affected a trustee charging or indemnity clause. See *In Re Butlin's Settlement Trusts* [1976] Ch. 251.

3 RV NOTE: In the following quotations I have added the Italics.

"2. It is an unusual claim. In brief it is that:

(1) the settlor intended to make a Potentially Exempt Transfer ("PET") of funds to the trustees of the settlement which was established for the benefit of the settlor's three children.

(2) The purpose was thereby to reduce the amount of inheritance tax which would be payable on his death.

(3) As was discovered in correspondence with the Inland Revenue following the settlor's death more than seven years later (9 February 2004), the terms of the settlement were not such as to achieve the intended result of saving tax.

(4) This was because the funds which had been transferred by the settlor to the trustees were not a PET and

(5) Inheritance tax was therefore payable in respect of the funds held by the trustees of the settlement. The trustees submitted that there was clear evidence of the settlor's true intentions and of his instructions to his solicitor. They contended that it was apparent that the settlement, as executed, was contrary to those intentions and instructions.

"3. The aim of those instructions was to achieve a saving of inheritance tax on his death. So he paid the sum of £550,000 to the trustees of the settlement in 1995 under a mistaken belief that the transfer would be a PET for inheritance tax purposes. It was not. The reason it was not was because the settlement contained discretionary trusts for the three children rather than creating interests in possession for them. The claim for rectification is that the settlement should be rewritten so that, instead of being a discretionary trust, it is an interest in possession trust, which would take effect as from the date of the execution of the original settlement. The settlement, as rectified, would then, it is argued, reflect the settlor's true intentions and would thereby achieve the intended tax saving. The interested parties, who are the beneficiaries under the settlement, being the settlor's three children, would obviously benefit from rectification if inheritance tax were not payable on their trust fund. Naturally, they consent to the relief claimed by the trustees."

3.3 The Law

Lord Justice Mummery then turn to the law regarding rectification.:

> "5. ... Mistake is undoubtedly a ground on which a court may set aside or rectify a voluntary settlement. Rectification is but one aspect of a wider equitable jurisdiction to relieve parties from the consequences of their mistakes.
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> 6. The judgment of Millett J in the case of *Gibbon v Mitchell* is a valuable illustration of *the limits of the remedy of rectification.* In page 5 of his judgment, having reviewed the authorities, he came to this conclusion about the jurisdiction of the court to set aside voluntary transactions on the grounds of mistake:
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> > "In my judgment these cases show that *wherever there is a voluntary transaction by which one party intends to confer a bounty on another, the deed will be set aside if the court is satisfied that the disponer did not intend the transaction to have the effect which it did. It will be set aside for mistake whether the mistake is a mistake of law or of fact so long as the mistake is as to the effect of the transaction itself and not merely as to its consequences or the advantages to be gained by entering into it.* The proposition that equity will never relieve against mistakes of law is clearly too widely stated in the authorities."
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> "7. Millett J was dealing with the jurisdiction of the court to set aside a voluntary transaction on the ground of mistake. But Millett J made it clear that *it was not a mistake of the kind for which rectification was available*. On the facts the settlor's intention was to make a marriage settlement but it could not be carried out either by the deed which he executed or by that deed as rectified, or indeed by any other deed, because what was required, on the facts of that case, was an application to the court under the Variation of Trusts Act 1958. It was apparent from the face of the marriage settlement itself that the settlor was mistaken in thinking that it was legally possible for him to effect his intentions by the deed which he executed. But the judge made it clear that the remedy was not to rectify the settlement but to set it aside and then to make an application to the court under the Variation of Trusts Act. Such an application was then made in that case and it was granted by Millett J."

Hence, there are mistakes which would justify setting a transaction aside yet which would not enable the instrument giving effect to that transaction to be rectified, so

that the transaction is retrospectively altered.

Lord Justice Mummery continued:

> "8. The relevance of that case to this is as follows. The trustees here do not ask this court to set aside the settlement on the grounds that a mistake was made by the settlor in executing a discretionary settlement instead of an interest in possession settlement. This is not surprising. The effect of setting aside this settlement would be that the funds would then form part of the settlor's estate and would be liable to inheritance tax. It is, of course, impossible for any new settlement to be executed, which would have the tax advantages that the settlor and his advisers hoped to achieve.
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> "9. The attraction of rectification is that, if it is available here, it will operate ex tunc[4] and the disposition in favour of the children in the trust would take effect under the rectified settlement as from 18 December 1995, from which date the settlor lived more than the seven years that were necessary to achieve the tax saving.
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> "10. I now turn to the trustees' arguments on this appeal. I will comment on them in the course of setting out my reasons for the decision that I have reached. The judge said that the function of the discretionary equitable remedy of rectification is:
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> > "to enable the parties to correct the way in which their transaction has been recorded".
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> "11. In other words, 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."*

The words "*or through a misunderstanding by those involved about the meanings of*

4 RV Note: i.e. "from then", meaning the date it was executed.

the words or expressions that were used in the document" represent a modern extension of the doctrine. However, I would warn against placing too much reliance on them. If the settlor or other donor wrongly thinks that words contained in an instrument he executes have one meaning but they have another, then rectification may be available. If the donor is conversant with the English language, that will normally be because the words used are technical legal words which he misunderstands. However, that does not mean that every mistake as to the legal effect of an instrument will found a claim for rectification.

3.4 Application of the Law to the Facts

Mummery LJ had no difficulty in agreeing that Judge in the Chancery Division:

> "12. Rimer J correctly commented that this case is far removed from the usual type of case in which rectification is, or might be, available. It is not a matter of correcting a mistake made in recording the settlor's intentions by inserting words or deleting words, or putting in different words because the words that are there have the wrong meaning. The claim made by the trustees involves substituting a wholly different settlement, an interest in possession settlement, in the place of the discretionary settlement, on the general ground that the substituted settlement would achieve the tax saving which the settlor intended to achieve, but failed to achieve by the document that he executed."

Not surprisingly the claim for rectification failed. The settlor could not show that he did not intend the trust to be discretionary. He was neither mistaken as to the contents of the instrument not did he misunderstand the meaning of the contents. As Mummery said:

> "19. I am unable to accept the trustees' submission on the availability of rectification in this case. The position is that the settlor intended to execute the settlement which he in fact executed, conferring benefits on his three children. The settlement correctly records his intention to benefit them through the medium of a trust rather than the alternative of making direct gifts in their favour. I am unable to see any mistake by the settlor in the recording of his intentions in the settlement. 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.

> "20. 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. I think that the judge put it well when he said the following in paragraph 23 of his judgment:
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> > 23. The case is therefore one in which I find that Mr Strain [that is, the settlor] intended to execute a settlement in exactly the form that Mr Wilding [that was the solicitor] drafted. Insofar as he was labouring under any sort of mistake when he did so, his mistake was not as to the language, terms, meaning or effect of the settlement. The only mistake was that a payment of the £550,000 to it would be a potentially exempt transfer.
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> > 24. In my judgment a mistake of that nature is not one which the court has any jurisdiction to rectify. Since, for the reasons given, Mr Strain must be assumed to have understood the meaning of the fact of the substantive trust the powers of the settlement he executed and to have intended to execute a settlement in that form and having the legal effect it did, there is no error in the drafting of the settlement or in his understanding of it that calls for correction. Mr Strain's only mistake was in relying in Mr Wilding's implicit advice that the payment of money to that settlement would be a potentially exempt transfer. That was wrong and apparently negligent advice, but in the circumstances of the case the remedy of rectification is not available to cure the damage it has caused."

Lord Justice Carnwath gave the only other reasoned judgment. He added:

> "26. I agree. I would only add this. The claimant's difficulty was not simply to establish a mistake such as would justify the intervention of the court, but also to show how the document should be corrected. The judge at paragraph 25 examined the alternative draft that had been put in front of him with the invitation that this should be the rectified form of the document. He concluded that, even if Mr Strain did not intend to establish a settlement in the form executed, the evidence fell short of proving that he intended the

settlement to incorporate the various trust powers and provisions set out in the alternative draft.

27. I agree with that conclusion and the supporting reasoning. That in my view is an additional reason why this appeal must fail."

Lord Justice Hooper agreed with both judgments.

4 Conclusion

While *Allnutt v Wilding* did not in my view alter the law, it did re-establish very clearly what in my view has always been the law. Recent cases, not incorrectly decided, have been misinterpreted by some practitioners as having extended the scope of rectification further than they in fact did. Hence, the decision is a useful reminder of the true position.