ASHCROFT V BARNSDALE: TAX CONSEQUENCES AND RECTIFICATION REVISITED

Harriet Brown[1]

On 30th July 2010 the High Court gave judgment in *Ashcroft v Barnsdale* [2010] EWHC 1948 (Ch). While the decision does not depart from the existing law it sets it out fully and clearly, explaining when tax consequences can be considered in the course of a rectification. In short, the fact that there are tax consequences which may be altered by the rectification, while not enough in and of itself to allow a rectification to proceed, will not prevent a rectification which meets the criteria for rectification from being granted.

The factual and tax background

The facts in *Ashcroft v Barnsdale* were relatively straightforward. The wife of the Claimant had died in 2006 leaving a will (the "**Will**"). The pertinent provisions of the Will were that:

(1) the Claimant was to receive £10,000 and all the Testatrix's freehold property which was occupied and farmed by the Testatrix or the Claimant; and

(2) the remainder of the estate was held on trust for the Testatrix's two children absolutely.

The net estate was worth £1.7 million and was comprised, principally, of farmland, shares and investments and a share in a farming business. The result of the Will was that the farmland passed to the Claimant (i.e. the husband of the Testatrix) and the residue to the children. Given that HMRC had accepted that agricultural property relief of 100% would apply to the farmland (under the Inheritance Tax Act 1984 ("**IHTA**"), section 116) this was inefficient for the purposes of inheritance tax.

1 Harriet Brown, Tax Chambers, 15 Old Square, Lincoln's Inn, London, WC2A 3UE. Tel: (020) 7242 2744

Property transferred to the Claimant (and exempt from charge under IHTA, section 18) would also be subject to the agricultural property relief ("**APR**") and as such, the APR would be lost.

In order to fully utilise the APR it was decided to enter into a deed of variation (the "**Deed of Variation**") by which the Claimant exchanged the farmland for a portion of the share portfolio, which did not attract any particular relief and so could (in the circumstances of the Testatrix's estate) only be free from inheritance tax if it was exempt under IHTA, section 18. Under the deed of variation the Claimant would be treated as the residuary beneficiary in order to achieve a result where the IHTA, section 18 exemption applied to all of the estate, save the property subject to APR and the portion of the share portfolio to be given to the children.

The intended result of this disposition, from a tax perspective, was that the only property upon which inheritance tax would be chargeable was the portion of the share portfolio which was to go to the children under the Will, as varied by the Deed of Variation.

Unfortunately, the Deed of Variation was deficient in several respects. In addition to the fact that the Deed of Variation deleted the wrong clause from the Will, it also contained the words:

> *I give the sum of £410,000 … to such of my children as shall be living at the date of my death and if more than one in equal shares … bequeath all my estate both realty and personalty whatsoever and wheresoever not otherwise disposed of by this my said Will to my husband …*

The relevant declarations to be made for IHTA, section 142(2) and the Taxation of Chargeable Gains Act 1992, section 62(7) were made. The defect in the Deed of Variation which it was sought to rectify arose from the monetary gift to the children. In addition to being in the wrong amount it caused an unexpected inheritance tax liability to arise.

The additional charge arose under IHTA, section 211. This provides:

> *(1) Where personal representatives are liable for tax on the value transferred by a chargeable transfer made on death, the tax shall be treated as part of the general testamentary and administration expenses of the estate, but only so far as it is attributable to the value of property in the United Kingdom which—*
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> *(a) vests in the deceased's personal representatives, and*
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> *(b) was not immediately before the death comprised in a settlement.*

> *(2) Subsection (1) above shall have effect subject to any contrary intention shown by the deceased in his will.*
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> *(3) Where any amount of tax paid by personal representatives on the value transferred by a chargeable transfer made on death does not fall to be borne as part of the general testamentary and administration expenses of the estate, that amount shall, where occasion requires, be repaid to them by the person in whom the property to the value of which the tax is attributable is vested.*
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> *(4) References in this section to tax include references to interest on tax*

This caused the gift of the children to be treated as free of tax (because there was no express contrary intention, as envisaged by section 211(2), expressed in the Will or Deed of Variation) and the gift had, therefore, to be grossed up in accordance with IHTA, section 38. This meant that there was (in addition to the tax to be paid in any event) an additional liability to inheritance tax of £33,000. In accordance with IHTA, s. 211(1), the burden of paying this liability fell on the residuary estate, and was to be taken from the Claimant's share.

The rectification to correct this error was a very simple one. The error could be rectified by simply inserting the words (or similar words) "*subject to inheritance tax*" after "*I give the sum of £410,000*". The Claimant tried to rectify the matter with a deed of rectification but HMRC insisted on a rectification by the Courts. There are, of course, certain rules established by case law to determine whether or not a rectification will be allowed.

This summarises the events and actions which led to the need to rectify the Deed of Variation, and can in part explain the confusion[2] that can arise in relation to rectification where there are tax consequences arising from that rectification. The factual (and legal) background to such applications is in general complex and it can be difficult to distinguish between that which is merely a tax consequence, albeit unintended, and a mistake which is capable of rectification by virtue of the fact that without rectification the document in question does not effect the agreement of the parties to it.

The legal requirements for rectification

The courts will not rectify documents on the least provocation. Over the years a set of common law rules have developed to determine which mistakes the court will rectify and which it will not. The basic conditions can be summarised as follows:

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2 See, for example, the STEP Journal of 2 September 2010 – "Court agrees to rectify deed of variation because of IHT consequences"

(1) there must be evidence of the intention of the party or parties[3] which is of sufficient strength to contradict the inherent probability that the written instrument truly reflects their intention;

(2) that there is an issue, capable of being contested, between the parties or between a covenantor or a grantor and the person he intended to benefit;

(3) in cases of common mistake it must be shown that there was a prior agreement between the parties which was still effective at the time the instrument was executed and that the mistake caused the instrument to fail to carry out that agreement;

(4) the proposed rectification would give effect to the prior agreement; and

(5) there is no other convenient remedy by which the parties' common intention can be effected.

It is sometimes erroneously considered that the matter of the fiscal effect of the rectification is an additional requirement. This is not, however, the case. Whether or not the only outcome of the rectification is a fiscal effect will go towards whether or not conditions (2) and (3) are met. This is examined in at least two earlier cases.

The first of these cases is *Racal Group Services Limited v Ashmore* [1995] STC 1151. This was a Court of Appeal decision. The head note of the report briefly summarises the factual (including the tax consequences) background to the case:

> *By a resolution … the parent of RGSL [a company] resolved that for the year ending 31 March 1989 … a gross sum of £70,000 (or if more tax efficient a covenant providing for an annual payment of that amount for four years) should be made available by RGSL to RECT (a charitable trust) … the deed [was drafted] on the basis that the first payment would be made on its execution but that future payments would be expressed to be made on 1 April in each subsequent year. In the first draft the covenant was expressed to be for a period of four years from its execution and under it RGSL covenanted to pay to the trust £70,000 annually*
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> *'the first annual payment to be made on the date hereof and the subsequent annual payments to be made on 1 April in each of the following three years, the last payment to be made on 1 April 1992.'*

3 The rules are modified in cases where rectification is sought of a document to which there is only one party

> *… [there was] noticed the discrepancy between the number of payments (three) and the date of the last payment (1 April 1992). On the basis that there was a typographical error the deed was amended so that the last payment was expressed to be made on 1 April 1991 … Initially RGSL deducted tax at the basic rate … and the trust recovered the tax paid from the Revenue. However, the Revenue discovered that the payments were not covenanted payments to charity … since the period for which the annual payments became payable … was not a period exceeding three years. On that basis … the payments were deemed to be the income of RGSL, not the … RGSL applied for an order rectifying the covenant by substituting for the words 'on 1 April in each of the following THREE years, the last payment to be made on 1 April 1991' the words 'on the same day in each of the following three years, the last payment to be made on 19 July 1991'.*

The rectification was refused by Vinelott J in the High Court on the grounds that there was no issue between the parties, and in the absence of an issue the court would not order rectification where the only effect would be to obtain a fiscal benefit and that RGSL had not established to the necessary standard that the covenant did not give effect to its intention. It was, however, allowed by the Court of Appeal. In giving the first judgment, Gibson LJ stated:

> *The judge summarised the effect of the authorities in this way (at 425):*
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> *'In my judgment the principle established by these cases is that the court will make an order for the rectification of a document if satisfied [1] that it does not give effect to the true agreement or arrangement between the parties, or to the true intention of a grantor or covenantor and if satisfied [2] that there is an issue, capable of being contested, between the parties or between a covenantor or a grantor and the person he intended to benefit …*

The judgment of Vinelott J, quoted by Gibson LJ, then goes on to discuss the things which are not relevant to determining whether or not rectification will be ordered. The judgment continues:

> *… it being irrelevant first [1] that rectification of the document is sought or consented to by them all, and second [2] that rectification is desired because it has beneficial fiscal consequences.*

Thus the fact that there are fiscal consequences will not be taken as determining the issue against ordering rectification where the conditions for rectification are otherwise met. In short, should HMRC argue that a document should not be rectified because it resulted in a loss of tax to HMRC, this should not be enough to prevent rectification where the document otherwise qualified for rectification. Finally Vinelott J went on to consider when rectification will not be ordered. Gibson LJ also quoted this part of the judgment with approval:

> *On the other hand, the court will not order rectification of a document as between the parties or as between a grantor or covenantor and an intended beneficiary, if their rights will be unaffected and if the only effect of the order will be to secure a fiscal benefit.*

This is not an additional requirement for rectification. Rather it is an explanation of one type of circumstances which will not constitute an issue between the parties and/or whether or not the document truly reflects the common intention of the parties. Fiscal consequences, not effecting the rights as between the parties, will not be sufficient absent other issues affecting rights as between the parties to render a mistake one eligible for rectification.

The second case was *Allnutt v Wilding* [2007] EWCA Civ 412. Mummery LJ summarised the circumstances leading to the application for rectification in paragraph 2 of his judgment. He said:

> *(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.*
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> *(2) The purpose was thereby to reduce the amount of inheritance tax which would be payable on his death.*
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> *(3) As was discovered … following the settlor's death more than seven years' later … the terms of the settlement were not such as to achieve the intended result of saving tax.*
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> *(4) This was because the funds which had been transferred by the settlor to the trustees were not a PET and*
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> *(5) Inheritance tax was therefore payable in respect of the funds held by the trustees of the settlement …*
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> *… 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 Court of Appeal rejected the application for rectification. In giving the Court's judgment Mummery LJ held:

> *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.*
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> *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 …*

This clearly highlights the distinction which has been the cause of some confusion. In *Allnutt v Wilding* the intention had been to create a discretionary trust. The belief was that this would create an inheritance tax saving. In the event, this belief was erroneous, but this did not change the fact that the intention had been to create discretionary trust. It is possible that, in some cases of this nature, a suitable remedy may be found in setting aside, or under the principle in *Hastings-Bass* (where the matter relates to actions of trustees).

Ashcroft v Barnsdale: **why it doesn't change the law**

Hodge QC, sitting as a judge of the High Court gave the decision in *Ashcroft v Barnsdale*. He recognised the distinction between intention and effect at paragraph 15 of his judgment saying:

> *it would be contrary both to principle and to authority to confine the distinction (which I acknowledge is not always an easy one to grasp) between a mistake as to the meaning or effect of a document (which may be amenable to rectification) and one as to its consequences (which is not) to cases involving voluntary transactions. I consider that it applies to all claims for rectification. So far as principle is concerned, the relevance of the distinction does not depend upon the nature of the document which it is sought to rectify. Rather, it is a limitation which is inherent in the nature of the equitable remedy itself: the function of rectification is to enable the court to put the record straight by correcting a mistake in the way in which the parties have chosen to record their transaction; it does not empower the*

> *court to change the substance of that transaction or to correct an error in the transaction itself. So far as authority is concerned, there is no warrant in Allnutt itself (or in any of the other cases) for confining the distinction to cases of voluntary transactions …*
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> *So long as a mistake relates to the meaning or effect of a document (rather than the consequences of, or the advantages to be gained from, entering into it), relief may be available even though the actual words of the document were deliberately adopted by the parties. It is now firmly established that the fact that the parties intended to use a particular form of words in the mistaken belief that it was achieving their common intention does not prevent the court from giving effect to their true intention*

In applying these principles to the circumstances of *Ashcroft v Barnsdale* Hodge QC held (at paragraph 20:

> *I am satisfied that this is not a case where the parties merely proceeded under a misapprehension as to the true fiscal consequences of the Deed of Variation as actually drafted. Rather, the Claimant has demonstrated* ***a specific common intention as to how the parties' fiscal objectives were to be achieved****; and he has established that, owing to a mistake in the way in which that intention was expressed in the Deed of Variation, effect has not been given to that intention. Underlying the parties' adoption of the Deed of Variation* ***was the common intention, unarticulated and unexpressed, that the Claimant should receive his entitlement under his late wife's will, as varied, free from all liability for inheritance tax, thereby replicating the position under the Will as executed. There was never any intention to vary the burden of, or the incidence of the parties' liability for, inheritance tax****. To the extent that the Deed of Variation had this effect, then it was executed under a relevant mistake, because it failed to give effect to the parties' true intention. To paraphrase the approach of Sir Raymond Evershed MR in Whiteside v Whiteside [1950] Ch 65 at 74, the mistake consisted in using language to perfect an agreement which in law had some result different from the common intention: the fact that the mistake arose from the legal effect of the language used in the Deed of Variation provides a ground for the exercise of the court's reforming power. The truth is that the parties, and their professional advisors, failed to appreciate that, in order to achieve their true objective, they needed to insert the words "subject to inheritance tax" in clause 2.1(a) of the Will as varied …*
> (emphasis added).

It is only in this paragraph that it really becomes clear why, in this case, where the driving force behind the rectification was the refusal of HMRC to accept the deed of rectification as having an impact on the fiscal consequences of the Deed of Variation, that rectification was allowed. Undoubtedly the Deed of Variation was

executed to achieve a beneficial fiscal consequence, namely the saving of inheritance tax by ensuring that the APR available was fully exploited and not lost by being applied to property which was also subject to the spouse exemption. The way in which this intention had been carried out had resulted in an unexpected charge to tax. This by itself would not have been enough for the rectification, as this would clearly only have been a mistake as to the fiscal consequences of the Deed of Variation, not a mistake in the recording of the parties' common intention the result of which was that that common intention was not effected.

The fact was that there had been an intention that the burden of tax as between the Claimant and the other beneficiaries under the Will was not to have been altered, i.e. any tax should have been borne by the property given to the children. This was both the issue between the parties (i.e. that a party who had not been intended to bear the burden of tax had been left so to do) and the mistake in the recording of the common intention, which was for the children to bear any inheritance tax on their share. One very fortunate outcome of the rectification was that there would be less inheritance tax on the estate, but this is irrelevant for the purposes of determining whether or not rectification should be ordered.

This may appear to give an unfair result – where some people can obtain their intended beneficial fiscal consequences and others cannot, and it does (as far as the tax result is concerned) produce results that are random. This is, however, easily explained. When concentrating on the fiscal implications of a transaction it is easy to forget that the practical implications of a transaction are at least as important. Rectification is a remedy where an agreement has been incorrectly recorded, not where an agreement has been correctly recorded but the implications of that agreement have been misunderstood. It is often said (in the context of tax planning) that the tax tail should not be allowed to wag the practical dog. All that *Ashcroft v Barnsdale* does is reiterate that the courts will not be distracted from the practical intentions and outcomes of an agreement (which are what is relevant to the transaction) by the tax consequences of that agreement.