TAX ASPECTS OF RECTIFICATION

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It sometimes happens that the parties to a transaction execute a written contract which fails to express the true bargain made by them. In the commercial world, such mistakes are easily corrected by entering into a supplementary contract, so long as the parties can actually agree as to what they actually intended. The initial mistake can then be forgotten. Unfortunately, that does not always work from a taxation point of view, particularly when a significant period of time has elapsed between the execution of the contract and the discovery of the mistake – payments may have been made or received in that period. The Revenue may (understandably) take the view that, in taxing or relieving those payments, the provisions in the original contract should be taken at their face value. That is where rectification can come into play.

Rectification is the equitable remedy under which the Court orders the correction of instruments (which can include both contracts and trusts) so that their text, *as rectified*, expresses the actual agreement of the parties. The order for rectification enables the parties to point to the *as rectified* text as governing all the acts carried out under the contract, even if those acts took place before the date of the order. This is generally sufficient to persuade the Revenue to look only at the agreement in its rectified state when considering its taxation consequences.

The Court does not, however, hand down orders for rectification at the drop of a hat. It generally[1] requires the Claimant to show five things:-

1. *A prior firm accord, usually outwardly expressed*. If there is insufficient evidence as to what the parties actually agreed, the Court will not rectify the document. The Court does not rewrite bargains to make them more commercially effective;

2. *A common continuing intention up to the time of the execution of the agreement.* It will not do for the parties to have changed their minds between reaching agreement and executing the original agreement. If they did, then the mistake becomes one–sided and the Court will not help;

3. *Clear evidence ("strong irrefragable evidence[2]") that the agreement as executed did not reflect that common intention*;

4. *That the wording contended for by the Claimant will accurately reflect the agreement*; and

5. *That there is an issue between the parties capable of being contested.*

Evidence of the parties' intentions is admissible in rectification proceedings. This is not true in proceedings where the meaning of a document is in dispute[3] – consequently the Court will not accept flimsy evidence. The burden of proof has been said to be greater than the usual "balance of probabilities" but not as high as "beyond reasonable doubt".

Tax as a Motive for Rectification?

Many of the reported decisions on rectification are tax driven. This is not surprising. Even if the parties are able to agree among themselves that an executed document does not express the actual intention of the parties, the Inland Revenue may seek to tax them on the words of the document. That may force the parties to consider rectification as an alternative to arguing away from the meaning of the words used in the document in a tax appeal. The mere fact that the rectification sought will yield a tax advantage to a party is not in itself a bar to relief. See *Whiteside v. Whiteside* [1950] Ch 65 (payments would have been deductible for surtax) and *Re Slocock's Will Trusts* [1979] 1 All E.R. 358 (CTT saving). So the Court will not refuse to make an order on these grounds. But an intention to secure a particular tax result without any clear agreement as to the terms which would secure that result will not do. It will fail as many as four of the Court's requirements. In *Racal Group Services v. Ashmore* 68 Tax Cases 86 there was evidence that the deed of covenant in question had been made with the clear intention that each payment to be made under it should qualify as a charitable covenant that would be a charge on income for the payer. Unfortunately, the payment dates actually chosen and inserted into the deed were not more than three years apart, so the deed could not qualify and the payments could not be deductible as charges on income. There was no evidence to show that the parties had intended to pay on any other dates, so there could be no rectification. Again, the Court's role is not to recast transactions, but to state them accurately when the parties have failed to do so. It is not sufficient for the mistake to be as to the consequences of the transaction.

This is extremely significant where the parties act in accordance with complex advice – if they do not understand the details of the transaction they are entering into, rectification may not be available. However, more recent decisions are suggesting that this strict approach may be softening. See for example *AMP (UK) v. Barker* [2001] Pens L.R. 77, where Lawrence Collins J described the prohibition on rectification when the mistake is as to consequences as "[i]f anything … simply a formula designed to ensure that the policy involved in equitable relief is effectuated to keep it within reasonable bounds and to ensure that it is not used simply when parties are mistaken about the commercial effects of their transactions or have second thoughts about them. The cases certainly establish that relief may be available if there is a mistake as to law or the legal consequences of an agreement or settlement."

"Rectifying" by Executing Further Documents

In *Whiteside v. Whiteside* (above) the parties sought to cure the apparent defect in a deed of covenant by executing a supplementary deed. This was fatal to the subsequent claim for rectification because there was no longer an issue between them. Presumably the Inland Revenue had refused to accept that the supplementary deed could operate retrospectively so as to alter the character of the payments already made.

Documents That Have Run Their Course

This is another aspect of the requirement that there must be an issue between the parties. In *Toronto-Dominion Bank v. Oberoi* 75 Tax Cases 244 the 26-month residential lease in respect of which rectification was sought had expired by the time that proceedings were started. This raised the question as to whether there was an issue between the parties – the tenant had paid all amounts due under the lease and had had the use of the premises, which had been occupied by one of its employees. The clearly expressed intention of the parties was that the £345,000 paid in advance to the landlord would be a premium, but the document called it a rent throughout. The tax consequences for both employee and landlord were radically affected, but, that apart, the parties had had their bargain. The High Court held that there was an issue between the parties because the intended premium had been set at £345,000 (significantly in excess of the level of rent) so as to compensate the landlord for the inability fully to deduct mortgage interest against the premium – the premium being taxable at the start of the lease, there was nothing against which mortgage interest could be set in the second and third tax years in which the lease existed. So if the £345,000 payment was not a premium, but was (as the document said) in fact rent, the whole basis on which it was calculated was wrong and the Claimant was (arguably) able to require that part of it should be repaid. The Court did not decide that the Bank would in fact have been able to recover this "overpayment", but was satisfied that there need only be an arguable case for requirement 5 (above) to be satisfied.

Evidence

The requirement for strong evidence that the instrument does not reflect the intention of the parties can present significant difficulties when a particular tax consequence is desired, but the principals have no clear understanding of the steps that will achieve that consequence. In *Toronto-Dominion*, the careful written advice of the Bank's accountants as to what the new lease should do and say was seen by or explained to all parties, except the draftsman of the lease. Had that not happened, the claim would probably have fared no better than the claim in *Racal*.

Involving the Revenue in Rectification Actions

Tax-driven rectification actions are usually only necessary when the Revenue insists on taxing in accordance with the executed document or the parties fear that that is what the Revenue will attempt to do. But does an order for rectification bind the Revenue if it is not party to the proceedings? Might the Revenue be able to take a different view of the facts and pursue a tax appeal on the basis of the original instrument? That might be inadvisable in practice, but the Revenue certainly keeps its options open here. In *Slocock* (above), it was not a party, but said in correspondence that it would be bound by the decision "provided that the order does not appear wrong for any reason". This point tends to be theoretical only, because before launching any rectification action, the parties should ensure that the Revenue is made aware of it and asked whether it wishes to be joined as a party. The stock Revenue response to this is that it does not wish to be joined, but will accept the decision, provided that the relevant authorities are drawn to the Court's attention[4]. But there are occasions where the Revenue does wish to be joined and will argue against rectification. See *Toronto-Dominion*, where the defendants did not oppose the application, but the Revenue did, albeit unsuccessfully.

Key Points

1. The commercial temptation to clarify or amend documents can easily prejudice the tax outcome by making rectification impossible.

2. When that happens, the Revenue may refuse to accept that the amendments agreed by the parties have any retrospective force and may accordingly seek to tax on the basis of the original document, at least until the date of the amendments.

3. If the Revenue does take that approach, the precise nature of what was originally agreed would have to be argued before the Commissioners in a tax appeal. Given that there will be a document which contradicts the parties' evidence, the prospects of a successful appeal may be severely compromised.

4. Even if the Commissioners could be persuaded to give rectification "by the back door" after receiving evidence of what the parties actually did intend, it does not follow that the tax outcome would be the same. Some tax outcomes only happen if a document contains prescribed provisions (e.g. pension scheme deeds), and it is difficult to see how the Commissioners could go behind the document in such a case and pretend that an omitted provision was actually present.

5. The later a tax-based rectification claim is brought, the greater the risk that there will no longer be an issue between the parties. If the premium in *Toronto-Dominion* had been for the same amount as the previously negotiated aggregate rental, the outcome might well have been different.

6. It is vital to involve the Revenue in a rectification in some way so as to ensure that, one way or another, it is bound by the result.

7. Even if rectification is obtained, it is important to remember that it does not prevent the Revenue from arguing that the tax treatment of the underlying transaction may be affected by other factors. *Toronto-Dominion* (above) involved the termination of a residential lease at a rent and (as rectified) the granting of a new lease of the same house for just over two years at a premium, with the Bank's employee remaining in occupation throughout. There were provisions for the return of the premium in the event of early termination, which could have occurred if the landlord had returned to the United Kingdom. In theory, the Revenue could, after rectification was ordered, have argued at the Special Commissioners that the benefits in kind legislation applied to the premium as though it were a rent, either under *Furniss v. Dawson* or as a matter of construction generally, but they chose not to do so.

8. Rectification can have more than one tax effect. In *Toronto-Dominion*, the employee's liability under Schedule E was greatly reduced, but the Schedule A liability of the landlord was increased because he had taxable income in the first year only, with unrelievable interest expenses in the second year. In *Slocock*, there was an improved CTT result, but the retrospective effect of the order redirected past income to two of the parties. The income tax liability would therefore have shifted to them and there would arguably have been nothing to prevent the Revenue from raising discovery assessments on those parties.

9. The position of a person who originally received income, but who, post rectification, was no longer was entitled to it, would have to be taken into account when considering rectification. If they had already paid income tax on that income, an "error or mistake" claim might be possible under s. 33 Taxes Management Act 1970, but that is by no means certain.

10. Even where a rectification action is not tax-based, it may nevertheless have tax effects if the action is successful. Consideration should always be given to the potential taxation effects of any rectification action and to the making of an approach to the Revenue to secure its acceptance of the consequences of any order of the Court.

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[1] The leading modern authority is *Joscelyne v. Nissen* [1970] 2 Q.B. 86
[2] *Shelburne (Countess) v. Inchiquin (Earl)* 1. Bro. C.C. 338
[3] *Prenn v. Simmonds* [1971] 1 WLR 1381
[4] The Revenue helpfully says which authorities should be cited to the Court: usually *Whiteside*, *Slocock* and *Racal*.