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Setting aside subsequent transfers into a Jersey trust due to mistake as to potential tax consequences: In the Matter of the D, E and F Trusts

In its decision in *In the Matter of the D, E and F Trusts* handed down in September 2016, the Royal Court applied Jersey's 2013 statutory mistake provisions for the first time to set aside transfers of shares into three Jersey trusts a number of years after the trusts were established and in circumstances where the mistake in question gave rise to a contingent, rather than a crystallised tax liability. The Court also clarified that notwithstanding foreign law governed the transfers of the shares to the trusts, Jersey's firewall provisions required the question of the validity of those transfers to be determined under Jersey law.

The application

The application concerned the transfer of shares in Luxembourg companies (which in turn held substantial shareholdings in a public company) by a Settlor in 2011 to be held on three Jersey law trusts: the D Trust, E Trust and F Trust (together the **Trusts**) (the **Transfers**). The Trusts had originally been established in 2009 with the settlement of a nominal cash sum, but were amended in 2011. The Trusts were settled to benefit the Settlor during his lifetime and his family thereafter, but also to achieve certain US tax objectives, the most relevant being to ensure that any distributions to the Settlor's two sons were not subject to US tax and to ensure that no part of the assets held by the Trusts would be subject to US estate tax upon the death of the Settlor (who was Swiss resident) or either of his sons (who were both US resident).

The amendments to the Trusts in 2011 were effected to mitigate against a potential change in Swiss estate tax law, the effect of which would have been to expose the Settlor's assets (including

the valuable shareholdings subsequently transferred to the Trusts) to a substantial Swiss estate tax charge. On making the amendments, however, it was also important for the Trusts to continue to achieve the original US tax objectives. The provisions of US and Swiss law required different principal features for the Trusts, although none of which were mutually exclusive - the Settlor obtained advice on the proposed amendments in order to adopt changes that would address the competing risks of US tax liability and the potential Swiss tax liability.

The amended Trusts were stated to comprise completed gifts to the Settlor's sons and, in the event of their death prior to the expiry of the Trusts, to their children and his grandchildren. Each Trust had three Trustees (respectively called the family, administrative and independent trustee, the latter of which held dispositive powers). The Settlor's sons were the family trustee of the D Trust and the E Trust respectively, and together the family trustees of the F Trust. The sons were also protectors.

The amendments to the Trusts introduced an unintended provision that gave rise to a potentially significant US tax liability, by granting to each of the sons in their respective capacities as protectors of the Trusts, the power to remove the independent trustee and appoint as independent trustee, himself or a person related or subordinate to him. The power as drafted, (which had been addressed in an early draft by the US lawyers but was not identified in the final draft which had changed) amounted for the purposes of US tax law to a 'general power of appointment' over the Trust assets in favour of the sons. As a consequence, if the sons were to die prior to the expiration of the Trusts, the value of the respective Trust assets would be deemed to fall within their estates for US estate tax purposes and could attract US estate tax at a rate of up to 40%.

Ultimately the applicable Swiss tax law was not changed and therefore the Swiss tax risk fell away. However it was only some years later that the Settlor's advisors identified the risk of the US estate tax charge by reference to the power of appointment. There were no means under the Trusts instruments that could be adopted in an effective way for US tax purposes to remedy the issue. Therefore the Settlor applied to have the Transfers set aside and declared void on the grounds of mistake pursuant to Article 47E of the Trusts (Jersey) Law 1984 (the **Law**), with the effect that the shares would be declared to have been held at all times on bare trust by the trustees for the Settlor.

Decision

The decision confirms that where an application based on mistake does not seek to set aside the trust but, rather, seeks to set aside the disposition of assets on to the trust, and particularly if such transfers took place some time after the establishment of the trust, the application can squarely be brought under Article 47E of the Law. (The more typical remedy sought where the establishment of a trust and corresponding settlement of assets causes the tax problem is to set aside the trust itself under Article 11 of the Law).

The Court applied the three questions reflected in the 2013 amendments to the Law, namely: was there a mistake on the part of the Settlor? Would the Settlor not have made the Transfers but for the mistake? Was the mistake of so serious a character as to render it just for the Court to make a declaration?

The Court had no hesitation answering the first two questions affirmatively (based upon the error in the drafting of the Trusts instruments at the time of the amendment, noting the US tax advice subsequently received, and upon accepting the Settlor's affidavit evidence that he would not have made the Transfers had he known of the tax implications). The third question was a more difficult one. Whilst mistake applications have typically been brought in respect of mistakes which have given rise to an existing tax liability, in this case, the tax liability was entirely contingent upon either of the Settlor's sons dying prior to the expiry of the Trusts (in 2041). The Royal Court concluded that such a contingent risk could be a consequence which renders the mistake so serious that it is just that the transfers be set aside. Its reasoning included the following:

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<u>Court's consideration of conflicts of law</u>

The Royal Court also reviewed the scope and application of the firewall provisions set out in Article 9 of the Law. The agreements effecting the Transfers were governed by Swiss law save to the extent that Luxembourg law was compulsory or mandatory. The application was premised on the argument that Article 9 required the application of Jersey law to the question of the validity of the Transfers.

The Court agreed with the arguments advanced on behalf of the Settlor in that regard and also that the consequence of any order that the Transfers were invalid under Jersey law would merely result in the trustee, as transferee, holding the asset upon a different trust - namely as bare trustee for the transferor. On the facts, there was in any evidence from Ogier Luxembourg to the effect that a Jersey court order setting aside the Transfer could be used as a basis to rectify the share registers of the Luxembourg companies.

<u>Comment</u>

The decision provides a useful confirmation of the Court's approach to mistake applications

brought to address subsequent transfers in to Jersey trusts. It also provides much welcomed clarity on the application of Article 9 where different laws apply to the assets transferred (in this case the shares in a foreign company). For Trustees and settlors, the decision helpfully underlines the Court's willingness, in appropriate circumstances, to consider it just to set aside transfers made on the basis of a mistake and which give rise to contingent as opposed to crystallised liabilities.

A further point of practical note is that at the convening hearing commencing the application, the Court accepted that notice of the application was not required to be given to the potentially relevant tax authority. This was on the basis that no tax liability had yet crystallised in respect of the Transfers, and would only crystallise in the event of the Settlor's sons dying prior to the expiry of the Trust (which on the facts was remote given the ages of the sons) and that any future tax liability would not be a liability of the Settlor (not being US resident) but would be a burden on the his sons' estates. That approach was very much fact specific as typically, and particularly where the setting aside of a transfer for mistake would avoid a crystallised tax liability, the Court will order the relevant revenue authority to be given notice.

Ogier represented the Settlor in the application.

As regards other jurisdictions, Marcus Leese a partner in Ogier's Guernsey office notes that had the trust been governed by Guernsey law and the matter come before the Guernsey court for determination, we would have expected a similar ultimate outcome - albeit based on slightly different reasoning in one respect. The Guernsey legislative regime does not include any direct equivalent of the statutory mistake provisions found in the Jersey legislation. Accordingly, any Guernsey decision on a similar matter would be decided on the basis of the common law principles of mistake in Guernsey. The Guernsey firewall legislation is, however, very similar to that in Jersey and, therefore, the analysis in the case on that point would be expected to be the same.

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