COLLAS CRILL

Unwinding tax consequences: Sill just for trusts... just

JULY 2019

In the matter of the J Settlement [2019] JRC111, the case dealt with an application for a number of trustee resolutions to be declared voidable on grounds of mistake.

The application was made under Articles 47G and 47H of the Trusts (Jersey) Law 1984 ('the Law'). The former deals with the Royal Court's power to set aside the exercise of powers in relation to a trust due to a mistake, and the latter, with the Court's ability to set aside the exercise of powers where the fiduciary failed to take account of all and only relevant considerations (Jersey's statutory embodiment of the so-called 'Rule in Hastings-Bass').

Background

The J Settlement ('the Trust') was a discretionary trust and the economic settlor ('the Settlor') was its principal beneficiary. His status as economic settlor was the result of a number of loans which he had made to the Trust (of some £41million at the material time).

The trustee and the Settlor had engaged a leading firm of accountants to advise on the tax affairs relevant to both the Trust and the Settlor. Restructuring advice was given ahead of the introduction of the UK Finance Bill 2017, the result of which meant that the Settlor was to become deemed UK domiciled for all tax purposes with effect from 6 April 2017. This meant that, absent a repayment or adjustment of the Settlor's loan to the Trust before 6 April 2017, the Trust would become tainted which would give rise to adverse income and capital gains tax consequences.

Prior to restructuring, the assets of the Trust comprised of: two ordinary shares (the then-entire share capital) in a Jersey company ('Company D'), owned by nominees for the trustee; the share capital of another Jersey company, which held an investment portfolio for the Trust; and an £18m loan receivable from Company D.

The accountants produced a written restructuring report, part of which set out recommendations for the Settlor's loan to be repaid. The proposals included several key stages:

1. A bonus issue of 'A' redeemable preference shares ('the A Shares') by Company D to the trustee (representing gains on Company D's assets) and the subsequent transfer to the Settlor of the A shares by way of partial repayment of his loan to the Trust.
2. Company D would then convert its £18m loan payable to the trustee into a second class of 'B' redeemable preference shares ('the B Shares') to be issued to the trustee by way of repayment of that loan payable.

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3. The B Shares would then be transferred by the trustee to the Settlor by way of further repayment of his loan to the Trust.
4. The ordinary shares in Company D would then be appointed to the Settlor and the balance of the Settlor's loan would be repaid by appointment to him of the remaining Trust assets. The Trust would then be wound up.

On 27 March 2017, the trustee accepted the advice and adopted resolutions giving effect to the proposals.

Consequently, and by various resolutions of the trustee's nominee shareholders and the directors of Company D, the new classes of redeemable preference shares were created (with new memorandum and articles of association being adopted to that end) and the A Shares and the B Shares were capitalised, issued and allotted to the trustee. The A Shares and the B Shares were then transferred to the Settlor in repayment of the Settlor's loan, together with the ordinary shares in Company D.

HMRC

The various restructuring arrangements were the subject of extensive correspondence between the accountants and HMRC, which showed that there had been complete transparency with HMRC.

The unforeseen tax consequences

As it turned out, the trustee's decision to procure the issue of the A Shares gave rise to an unforeseen UK income tax liability of approximately £1million on the trustee and approximately £200,000 on the Settlor.

The law of mistake

Article 47G

Under Article 47G of the Law, the court has the power in given circumstances to declare the exercise of a power by a trustee in relation to a trust or trust property voidable. Article 47G requires a mistake to have been made in the exercise of a power where such power would not have been exercised but for the mistake. The mistake must have been of so serious a character that it would be just for the court to grant the declaration.

Article 47H

Article 47H of the Law enables the court to set aside the exercise of fiduciary powers in relation to a trust or trust property in other given circumstances. Those are where, in relation to the exercise of the power, the trustee or person exercising the power failed to take into account all and only relevant considerations and would not have exercised the power (or at least not exercised it in that way) but for the failure.

Under Article 47I, subject to stated exceptions the Court may make such orders as it thinks fit which are consequential on setting aside the exercise of powers under Articles 47G and 47H.

Judgment

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The Royal Court took the view that it was really the decisions of the directors and shareholders of Company D relating to the A Shares which were sought to be set aside, those decisions having brought to fruition to the initiating decision of the trustee.

Whereas the trustee's decision was susceptible to being set aside under Articles 47G and 47H of the Law, that of itself would not necessarily mean that what had been done at company level ceased to have validity: *'[a] declaration that the trustee has taken a step which has no effect within the Trust does not it seems to us necessarily carry with it a decision about the validity or otherwise of what a separate juridical entity might have done in the meantime'*.

The Court resolved this point by determining that its jurisdiction to make orders concerning Company D as a Trust-owned company arose under Article 47I of the Law, namely the power to make orders consequential upon the setting aside of the trustee's decision. And on the facts, it was right to look at the actions taken by Company D as consequential upon decisions of the trustee.

The Court found that the trustee had been mistaken as to the tax consequences of its decision and that, but for the mistake, the trustee would not have made the decision that it did: the A Shares would not have been created or allocated and the trustee would have sought some alternative means by which to repay the Settlor's loan.

The justice of the case

The Royal Court then assessed whether the trustee's mistake was of so serious a character that it would be just to grant relief. The size of the potential loss was a relevant factor in assessing seriousness. And there had been no delay to the bringing of the application such as might lead the Court to refuse relief.

However, the Court was troubled by the issue of unwinding tax consequences in a trust context where there is no equivalent relief available where no trust is involved: *'[i]t is not obvious why the Courts should come to the rescue of a trustee or his professional advisers for a mistake that one or other might have made in circumstances where, had there been no trust, the trustee as client would have sued the professional adviser for the loss in question'*.

In dealing with this, the Court considered the judgment in Re Onorati Settlement [2013] (2) JLR 324, in which the Court had said it was not attracted by the proposition that beneficiaries should be left to a remedy of bringing litigation against trustees or professional advisers.

Ultimately, and extending the decision in Onorati to the trustees of the Trust in this case, the Court was not attracted to the prospect of the trustee being left to bring proceedings in negligence against the tax adviser. Accordingly, the Court found it just to grant relief in respect of the trustee's mistake and set aside the trustee's decision.

Necessary consequential orders and English law documentation

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In order to give effect to the setting aside of the trustee's decision, it was necessary not only to declare invalid the related decision-making of the nominee shareholders and the directors of Company D but also to set aside the memorandum and articles of association which had been adopted by Company D, together with certain other documentation which had been executed in connection with the loan repayment arrangements. The other documentation was governed by English law and granted exclusive jurisdiction to the courts of England and Wales. Nevertheless, by operation of Article 9 of the Law and following established cases in point, the Royal Court was satisfied that as part of the process it had jurisdiction to set aside the English-law documentation, which had a 'sufficient link' to the Jersey trust documents.

Health warnings

The Royal Court ended with a couple of health warnings for the purposes of future applications of this sort.

The first concerned aggressive tax avoidance. Whereas in this case there had been active disclosure and communication with HMRC, and there was no evidence to suggest an aggressive tax avoidance scheme, the Court said that if any external tax authority was to make such a contention in another case, that was potentially a matter which might impact on the Royal Court's exercise of discretion to grant relief.

The other caution related to the nature of consequential orders that might be made when setting aside a trustee decision. A judicial view expressed in another recent case in this field was that it was one thing for it to make orders as to the validity of transactions where those orders might have tax consequences but it was quite another thing, and no part of the business of the Court, to take a positive step to improve the taxation outcome or to select for one of the parties which order to make so as to achieve the best outcome (see In re B Trust [2019]JRC035 at paras. 41 and 42). Consistently with that thinking, the Court in this case said the following:

'There is in our judgment an important distinction to be made in relation to consequential orders under Article 47I between those orders which are directly consequential and those which amount to fresh steps designed to achieve the same tax benefits which, but for the mistake, would have been achieved if the transaction had not been declared voidable. In the latter case, the Court will scrutinise with great care exactly what it is asked to do bearing in mind that it is no part of the Court's function to facilitate foreign tax avoidance'.

Damian James appeared for the successful applicant trustee in this case.

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