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Can a Jersey foundation be set aside on the grounds of mistake?

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B and C v D, E, F and others [2020] JRC 169, Commissioner Clyde-Smith and Jurats Blampied and Thomas

In an important new judgment, the Royal Court of Jersey has considered whether it can set aside a foundation established and incorporated under Jersey law. Although the Royal Court has determined that it is unable to set aside the foundation itself, it is able to set aside endowments of property to the foundation on conventional application of the Jersey law of mistake.

Background

In 2009, the founders of the foundation (the "Founders") took estate planning advice from a UK tax adviser in relation to their financial affairs. In summary, the UK tax adviser proposed that the Founders:

- establish a Jersey foundation from which they would be excluded from benefit, but under which they reserved the right to demand repayment of the whole of any capital contributed to the Jersey foundation by them excluding any capital growth or income (the "Founders' Rights"); and
- once the foundation had been established, assign the Founders' Rights to their children.

The UK tax adviser noted that Her Majesty's Revenue and Customs ("HMRC") might regard such a foundation as a settlement for the purposes of United Kingdom inheritance tax ("UK IHT"). However, the UK tax adviser advised that because the Founders would retain the Founders' Rights (which would have a value equal to the assets transferred by them to the foundation) there would be no reduction in the value of their estates for UK IHT purposes.

The UK tax adviser further advised that when the Founders assigned the Founders' Rights to their children the assignments would be potentially exempt transfers and that accordingly there would be no UK IHT liability provided the Founders survived the assignments by seven years.

Following this advice, the foundation was established on 2 October 2012 under the Foundations (Jersey) Law 2009 (the "Foundations Law"). The beneficiaries of the foundation were the children of the Founders.

On 7 November 2012 the Founders executed a simple declaration of trust in which they declared that they held the Founders' Rights upon trust for such of their three children as shall attain the age of 30 years, and if more than one, in equal shares absolutely (the "Declaration of Trust").

During the year 2013 endowments totalling some £11.4 million were made by the Founders to the foundation.

The structure was reviewed in early 2019 as the Founders' eldest child was soon to turn 30. UK legal advice was taken. It became clear that the UK tax advice the Founders had received in 2012 was incorrect in at least three fundamental ways, namely that:

- the Declaration of Trust was not a potentially exempt transfer and accordingly was subject to an immediate charge to UK IHT;
- the use of the Founders' Rights mechanism did not prevent the occurrence of an event immediately chargeable to UK IHT at the rate of 20% (an entry charge); and
- the endowments to the Foundation did in fact constitute chargeable transfers for the purposes of UK IHT.

The Founders' liability to HMRC regarding UK IHT alone was estimated at between £4.7 million and £6.2 million.

The Founders, supported by their children, applied to the Court for a declaration that the foundation should be set aside *ab initio* on the grounds of mistake. The tax adviser was convened as a respondent to the application and was represented. HMRC was also convened but does not appear to have taken an active role.

Can a foundation be set aside?

There is no equivalent provision in the Foundations Law to Article 11 of the Trusts (Jersey) Law 1984 (the "Trusts Law"), which provides that a trust shall be invalid to the extent that the Court declares that it was established by, mistake.

The Founders and the Founders' children argued that a power to declare a foundation invalid on the grounds of mistake could be implied into the Foundations Law. However the Court was not prepared to imply a power to set aside foundations ab initio on grounds of mistake and/or exercise such a power if it existed for the following reasons:

A power to set aside would be contrary to public policy

Firstly, the Court found that if it declared the foundation void *ab initio* then there would be serious consequences for the ability of third parties to rely on the public register of foundations as confirming the existence of a foundation.

Article 29(3) of the Foundations Law provides that the entry in the register of the name of a foundation is *"conclusive evidence"* that the foundation was incorporated and the requirements of the Foundations Law were complied with in respect of all matters precedent or incidental to the incorporation of the foundation. However, if the Court set aside the foundation *ab initio* then the foundation would have never existed, notwithstanding that the public register would have shown the foundation as existing (or having existed).

The Court considered the analogous example of the register of companies and noted that there was no equivalent power for the Court to set aside the incorporation of a company *ab initio*.

The Court concluded that there was a strong public interest in third parties being able to rely on the relevant public register for any incorporated entity as *"conclusive evidence"* of the existence of an incorporated entity.

It is unnecessary to imply a power to set aside

The Court noted that as a matter of statutory construction, a court can imply a power into legislation where there is a clear necessity to do so. But the Court considered it was not necessary to imply a power to set aside a foundation *ab initio* into the Foundations Law given that the Court had a power to wind up a foundation on just and equitable grounds if necessary under the Foundations (Winding up) (Jersey) Regulations 2009.

What would happen to the assets of the foundation?

The Court noted that where a trust is declared invalid by the Court under Article 11 of the Trusts Law, no difficulty arises as to the application of the trust property held by the trustee. A trust is not a legal entity and on a declaration by the Court that a trust be set aside ab initio, the assets would remain in the legal ownership of the trustee and be held on trust for the settlor of those assets absolutely.

By contrast, a foundation is a legal entity and owns its assets both legally and beneficially. If the Court were to set aside a foundation *ab initio* with the effect that it never existed, then there will be no foundation to hold the foundation's assets and no council with power to deal with them. It is arguable that the assets of a foundation in these circumstances might pass to the Crown as *bona vacantia* (ownerless property).

For all of these reasons the Court was not prepared to set the Foundation aside.

However, the court can set aside the endowments to the foundation

The Court instead invoked its well-established jurisdiction to set aside voluntary dispositions of property on the grounds of mistake in respect of the endowments into the foundation.

The Trusts Law now provides for a statutory power to set aside transfers into trust on grounds of mistake (Article 47E). That provision was inapplicable in this case as the transfer was to the foundation rather than into trust.

Prior to enactment of Article 47E of the Trusts Law, the jurisdiction to set aside voluntary dispositions of property had been well developed in case law. While that case law was concerned mainly with dispositions into trusts, the Court confirmed that law is of general application to other voluntary dispositions of property and would apply to dispositions to Jersey foundations.

Just as in the Trusts Law, Article 32 of the Foundations Law requires that any question that arises in respect of the endowment of a foundation must be determined in accordance with the law of Jersey and (subject to specific exceptions) without reference to foreign law.

The Court applied the well-known three stage test (formulated in the case of *In the matter of the Lochmore Trust* [2010] JRC 068):

- Was there a mistake on the part of the donor?
- Would the donor not have entered into the transaction "but for" the mistake?
- Was the mistake of so serious a character as to render it unjust on the part of the donee to retain the property?

The Court was satisfied that the test was met in this case. There clearly was a mistake on the part of the Founders which operated on their minds in respect of each endowment they made to the foundation. In particular, they had understood the mechanism devised by their UK tax adviser in 2012 as being a

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tax efficient and a lawful way to pass assets to their children later in their lives and that it was established planning used by other individuals with similar objectives. They had now been advised that the endowments triggered significant and immediate UK IHT liabilities. The Court accepted that the Founders would not have made the endowments if had not been for their mistake and the quantum of the UK IHT liability was sufficient to render their mistake of so serious a character as to render it unjust for the Foundation to retain the endowments.

Comment

This case is important because it is the first case which considers the Court's ability to set aside voluntary dispositions of property to Jersey foundations on the grounds of mistake.

The Court's refusal to set the foundation itself aside is an orthodox approach to the existence and status of incorporated entities, and protects the reliability of the register of foundations as conclusive evidence of the existence of a Jersey foundation.

However, the Court's recognition of its jurisdiction to set aside endowments to foundations is welcome confirmation of the availability of a powerful remedy in cases where unwelcome and unanticipated tax consequences have arisen.

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