

TRUST & ESTATE PLANNING

When is a trust not a trust for tax purposes? When it is a “sham”

By Timothy W. Clarke

A trust is an obligation binding the trustee to deal with property for the benefit of one or more beneficiaries. A trust is formed when the settlor conveys property to a trustee to be held and used for the benefit of the beneficiary -- or a settlor indicates an intention to hold property for the benefit of the beneficiary by words or conduct.

The terms of a trust are frequently governed by a written declaration or deed conveying the property and describing the obligations imposed on the trustee. In such circumstances there is little question as to the trust's existence. But in cases involving aggressive tax plans, the tax authorities occasionally challenge the existence of a trust because it is a “sham”.

A sham is an act or document which is intended by the parties to give the appearance to others of creating legal rights and obligations that are different from the true legal rights and obligations. If a sham exists, the authorities will assess tax based on those true legal rights and obligations. This typically means that the settlor will be assessed rather than the beneficiaries or the trust because the trust is void ab initio.

A finding of sham requires a common intent by the settlor and trustee to deceive third parties or reckless indifference by the trustee as to whether the true legal relationship is captured by the documents. Without commonality or deceit there is no sham. The mental element does not require criminal intent



Timothy W. Clarke

or fraud. It is sufficient that the parties intend to give a false impression about the true legal rights and obligations. But because a sham requires dishonesty -- which may have serious implications to a professional trustee -- there is a strong presumption against such finding. And if the matter proceeds to court, the burden of proof is always on the person alleging sham.

A transaction cannot be genuine for one purpose and a sham for another although it is possible for one part of a trust declaration to be a sham while the rest is not. And once properly settled, a trust cannot subsequently become a sham.

Tax motivation, artificiality or an absence of commerciality is irrelevant. A transaction is not a sham merely because it was motivated by a desire to reduce tax or because it is artificial or

would not have been undertaken by parties dealing at arm's length in a commercial fashion. It is essential that the parties intend to disguise the true legal relationship whether the transaction is motivated by extraneous circumstances or not.

Whether a trust is a sham frequently turns on the presence or absence of control over the trust property by the settlor. Tax authorities occasionally argue that because the trustee has undertaken a carefully planned series of step transactions, the trustee has no discretion or control over the property and therefore there is no trust or the trustee is a mere agent of the settlor. But the jurisprudence indicates that a trustee is not obliged to say no to any particular transaction just to demonstrate his independence. Complying with the settlor's or the beneficiaries' wishes does not necessarily result in a sham.

It is sufficient that he conduct his own independent analysis and act in the best interests of the beneficiaries. In such circumstances it will be important for the settlor to appoint an experienced or professional trustee, that the trustee obtain his own legal, tax and accounting advice and that he exercise his own judgment and record the reason why he has decided to accede to those wishes.

It would not be surprising that a trustee would undertake every transaction suggested by the settlor or requested by beneficiary because a trust exists for the benefit of the beneficiaries. Although trustees occasionally undertake

...next page

transactions on their own initiative, this usually would be the case only in trusts involving infant, handicapped, incapacitated or spendthrift beneficiaries.

It is important that the relationship between trustee and beneficiary be harmonious. A lack of harmony may be a reason for a trustee to resign or be dismissed. The approach a trustee should adopt will depend upon the nature of the request, the interests of the other beneficiaries and all of the surrounding circumstances. If he is to exercise his powers in good faith, a trustee must be willing to reject the request if he thinks it is not in the best interests of the beneficiaries because it involves, for example, a risky investment or an ill-conceived tax plan.

But if a trustee concludes that the request is reasonable having regard to all of the circumstances and is in the

best interests of the beneficiary, he should not refuse it simply to demonstrate his independence. Indeed such a refusal could be a breach of trust if the request was truly in the best interests of the beneficiaries. Rejection would be an exception rather than the rule. One would expect there has not been a single refusal in the majority of trusts involving adult beneficiaries having full capacity.

To guard against an allegation or finding of sham, the settlor should carefully select an arm's length, experienced professional trustee and should never refer to the trust property as "my property" or include it in a list of his assets.

The trust property should be transferred to and be registered or otherwise recorded in the trustee's name. The trustee should make it clear to the settlor that although he may consider his or the beneficiaries' wishes, he now controls the trust property and will only

undertake a transaction that he considers to be in the best interests of the beneficiaries.

The trustee should keep separate bank accounts and books and records (including trustee resolutions) and ensure that all necessary tax returns are filed. And finally, the trustee should be well-versed on the particulars of the trust declaration and should consult it and his professional advisors before undertaking any transaction.



GGI member firm

Moodys Gartner Tax Law LLP

Tax, Law Firm,

Fiduciary & Estate Planning

Calgary, Edmonton, Canada

Timothy W. Clarke

E: tclarke@moodysgartner.com

W: www.moodysgartner.com