

Sham Trusts

When a family trust is really a sham

By **Margaret Rintoul and Aly Virani**



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(June 14, 2019, 9:31 AM EDT) -- Your client is the settlor of a family trust, one she claims was intended to be a gift to her children upon the last of the three children attaining the age of 30 years.

The trustees are your client's parents; the beneficiaries are your client's three minor children and their issue. The trust has effectively floated the family for more than a decade.

The parties have separated. The wife maintains that the trust's assets are neither hers nor her husband's, but belong to the children who are the beneficiaries, and therefore do not form part of the net family property. The husband, who is the children's father, counters that the trust is a *sham* that his wife uses to support the family's lavish lifestyle whilst shielding the assets from forming part of the net family property. As a result, he argues, the trust should be considered so as to increase the equalization payment to him by approximately \$10 million.

The husband has commenced an application in the Superior Court of Justice — family court. Your client and her parents in their capacity as trustees of the family trust are named as respondents. The key question for the trial judge is whether the family trust was intended to be a gift to the children or a sham to defeat the husband's equalization claims.

The issues are complex, but any analysis must start with the basics.

First, trusts are common vehicles of family and estate planning, particularly among high net worth individuals. A valid trust must have three essential characteristics: certainty of intention to create the trust (for the benefit of the beneficiaries); certainty of subject matter (of the property that will be held in trust); and certainty of objects (of the beneficiaries of the trust). The three certainties must also be identifiable in the trust deed (if one exists).

This having been said, the fact remains that some trusts — valid on their face because they meet the three criteria — are merely a pretense, or a sham, because the settlor had no intention of relinquishing control to the trustees, subject to their fiduciary duty to the beneficiaries. The upshot is that the trustees do not have genuine control over the property or the ability to exercise independent discretion.

Sham trusts, therefore, often involve the settlor making themselves the sole trustee, making themselves a trustee with veto power over other trustees, or naming wholly compliant trustees. In such circumstances, the sham trust is open to challenge on the basis that the relationship between settlor and trustees is in fact one of principal and agent.

What was intended?

The central focus in the investigation into a sham trust is the settlor's intent.

The intent required to establish a sham need not rise to the level of deceit required of actual fraud. What must be established, however, is that the settlor did not have the actual intent of parting with her beneficial interest in the trust, despite the fact that the documentation appears to have that effect.

Proving this intent is perhaps easier said than done, since looking at the trust deed will likely be of little or no assistance in unearthing the real intent behind the black letter words.

Additionally, the analysis of intent must be restricted to the time at which the trust was settled or created. If the settlor genuinely intends the trust to take effect according to its documented terms, and those terms create a trust, then nothing the settlor or trustees do thereafter can render the trust a sham. Still, the subsequent history of the trust can be important to establishing that original intent.

What matters in these circumstances?

Indicia of a sham include the absence of trustee resolutions, appropriate documentation, income tax filings, accounting records and bank accounts. Other relevant factors are evidence of the trust's inactivity; that only the settlor benefited from the trust; that the existence of the trust was not disclosed when required; and that underage beneficiaries were unaware of the trust before or even after they reached the age of majority. In extreme cases, courts will look to the well-known "badges of fraud."

Where a court determines that a trust is in fact a sham, it will treat the trust as an agency relationship between settlor and trustees. The upshot is that no benefits will be deemed to have accrued to the beneficiaries. In the family law context then, the alleged trust property will become net family property for equalization purposes.

Because an allegation that a trust is a sham raises delicate questions at the intersection of trust and family law, lawyers must ensure that their settlor clients provide the intended trustees with the appropriate degree of independence and discretion.

Should the issue come to a head, persuading a judge to rule either way will depend on evidence of the intent that existed when the trust was settled, including subsequent conduct and documentation (or lack thereof) that is relevant to proving that intent. As a rule, the way such intricate evidence is presented is best left to practitioners well versed in the nuances of trust and family law.

Finally, in our final article in this series, we will touch upon the key preventative measure that preserves the sanctity of family trusts — "the ounce of prevention," if you will.

Stay tuned.

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