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LECTURE TO
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on

SHAM TRUSTS

by

STUART PRYKE

Fiduciary Legal

5 North Court, Clevedon Road, London TW1 2HS

Tel: +44(0)7814495366 Email: stuart.pryke@fiduciarylegal.com

Web: www.fiduciarylegal.com

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SHAM TRUSTS

The Development of the law concerning sham transactions:

1. The early cases

One of the earliest reported cases concerning sham transactions is Yorkshire Railway Wagon Company v. Maclure [1882] 21 Ch D 309 (C.A.).

The case of Maclure concerned a sale and leaseback agreement between a railway company a wagon supply company concerning some rolling stock.

Lindley LJ at page 317 stated:

“I understand that the view the learned judge took was this, that this transaction of hire was a mere device or cloak to conceal a loan. If that had been the view I took of the facts, I should have come of course to the same conclusion. I should disregard or throw aside the cloak, and look at the real transaction alone. But for reasons I will give presently I am satisfied that the purchase and hire transaction was the real transaction, in this sense – that the parties meant it to operate according to its tenor as comprised in the deeds. It was not intended by them as a mere blind or cloak for something behind, it was a transaction substituted for another, but bona fide substituted, and intended to be acted upon according to its purport and apparent effect.”

Jessel MR stated at page 314:

“But even if the Wagon Company understood it [*the sale and leaseback agreement*] as a loan, in order to set aside the deed, that is to treat it as a nullity you must shew that the Railway Company were parties to the understanding.”

Stoneleigh Finance Ltd v. Phillips [1965] 2 QB 537

The case of *Stoneleigh Finance* concerned a hire purchase agreement between the plaintiff finance company and TS Ltd. In his judgement Seller LJ stated:

“The issue is one of fact. In its investigation into the facts it is the duty of the court to discover the true nature of the transaction to see whether the documents are a genuine statement of the intended transaction or are entered into only to clothe the real transaction in a deceptive manner ...”.

An important case is *Snook v. London & West Riding Investments Ltd* [1967] 2 QB 786.

In *Snook* both *Maclure* and *Stoneleigh Finance* were considered. The case concerned a hire purchase agreement between the plaintiff and the defendant finance company, which was entered into in order to refinance a car which was in the possession of P but had been subject to another hire purchase agreement between P and TI Ltd. In the hire purchase agreement between P and D the cash price for the car was stated as £800 and the initial payment to be £500 – these figures were fictitious. D paid out £300 of which £160 was paid to TI Ltd, £125 was paid to P and the intermediary finance company who filled out the figures kept £15.

In an action for the recovery of the car by D, it was held by the CA (Denning LJ dissenting) that the title to vehicle had passed to D who were not parties to the sham financing operation. It was found by Diplock LJ and Russell LJ that as D was not a party to the sham, P was estopped on basis of documents from denying D’s title to the car. At page 802 Diplock LJ stated:

“As regards the contention of the plaintiff that the transactions between himself, Auto Finance and the defendants were a “sham”, it is, I think, necessary to consider what, if any, legal concept is involved in the use of this popular and pejorative word. I apprehend that, if it has any meaning in law, it means acts done or documents executed by the parties to the “sham” which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create. But one thing, I think, is clear in legal principle, morality and the authorities (see *Yorkshire Railway Wagon Co v. Maclure* and *Stoneleigh Finance Ltd v. Phillips*), that for acts or documents to be a “sham”, with whatever legal consequences follow from this, all the parties thereto must have a common intention that the acts or documents are not to create the legal rights and obligations which they give the appearance of creating. No unexpressed intentions of a “shammer” affect the rights of a party whom he deceived. There is an express finding in this case that the defendants were not parties to the alleged “sham”. So this contention fails.”

2. Contemporary cases

Midland Bank Plc v. Wyatt [1995] 1 FLR 696 appears to be the earliest reported case concerning trusts in which the sham concept is considered in any detail.

The case of *Wyatt* concerned a property purchased in 1981 by D and his wife and was subject to a mortgage. In 1987 D entered into a trust deed with his wife, giving the equity in the property to his wife and 2 daughters (D's evidence, which appears to have been accepted by the Court, was that the purpose of entering into the deed was to protect D's family from the potential commercial consequences of a textile business which D was setting up). D's wife was apparently unaware of import and effect of the deed.

After quoting Diplock LJ's comments in *Snook – Young* QC stated at page 699.

“I do not understand Diplock LJ's observations regarding the requirement that all parties to the sham must have a common interest to be a necessary requirement in respect of all sham transactions. I consider a sham transaction will still remain a sham transaction even if one of the parties to it merely went along with the “shammer” not either knowing or caring about what he or she was signing. Such a person would still be a party to the sham and could not rely on any principle of estoppel such as was the case in *Snook* – the defendant there not being a party to the transaction at all.

I do not accept therefore the defendants' contention that it is a necessary requirement for the plaintiff to establish that both Mr Wyatt and Mrs Wyatt had a common intention that the declaration of trust signed by them was not intended to take effect and be acted upon by them as from the time of its execution.”

Young QC then states at page 707

“I do not believe Mr Wyatt had any intention when he executed the trust deed of endowing his children with his interest in Honer House, which at the time was his only real asset. I consider the trust deed was executed by him, not to be acted upon but to be put in the safe for a rainy day – as Mr Wyatt states in his affidavit, as a safeguard to protect his family from long term commercial risk should he set up his own company. As such I consider the declaration of trust was not what it purported to be but a pretence or, as it is sometimes referred to, a ‘sham’. The fact that Mr

Wyatt executed the deed with the benefit of legal advice from Mr Ellis does not in my view affect the status of the transaction. It follows that even if the deed was entered into without any dishonest or fraudulent motive but was entered into on the basis of mistaken advice, in my judgment such a transaction will still be void and therefore an unenforceable transaction if it was not intended to be acted upon but was entered into for some different or ulterior motive. Accordingly, I find that the declaration of trust sought to be relied upon by Mr Wyatt is void and unenforceable.”

Other relevant sham cases:

Abdel Rahman v. Chase Bank (C.I.) Trust Company & Others 6th June 1991 Royal Court of Jersey. This case concerned a Jersey law settlement of which D was trustee. The trustee had the power to apply capital and income to or for benefit of settlor and to have regard to settlor’s interests exclusively when deciding whether to exercise this power. The settlor retained power to appoint income and capital on such trusts as he should appoint with consent of the trustees subject to retained power by the settlor to appoint 1/3 of the capital without the trustees’ consent. The settlor referred to trust fund as ‘his assets’. The trustee made no independent investment decisions and often the settlor controlled the trust funds directly. The Court held that the trust was sham.

Hitch & Ors v. Stone [2001] STC 214 [C.A.] is another important case concerning sham transactions although it was not concerned with trusts. The case concerned a tax avoidance scheme which involved an agreement between a farming family and certain companies and included a lease of the family farm to these companies. The dicta of Diplock LJ in *Snook* was cited as the appropriate test for a sham. At pages 229 and 230 after referring to the case of *Snook*, Arden LJ stated as follows:

“An inquiry as to whether an act or document is a sham requires careful analysis of the facts and the following points emerge from the authorities.

First, in the case of a document, the court is not restricted to examining the four corners of the document. It may examine external evidence. This will include the parties’ explanations and circumstantial evidence, such as evidence of the subsequent conduct of the parties.

Second, as the passage from *Snook* makes clear, the test of intention is subjective. The parties must have intended to create different rights and obligations from those appearing from (say) the relevant document, and in addition they must have intended to give a false impression of those rights and obligations to third parties.

Third, the fact that the act or document is uncommercial, or even artificial, does not mean it is a sham. A distinction is to be drawn between the situation where parties make an agreement which is unfavourable to one of them, or artificial, and a situation where they intend some other arrangement to bind them. In the former situation, they intend the agreement to take effect according to its tenor. In the latter situation, the agreement is not to bind their relationship.

Fourth, the fact that parties subsequently depart from an agreement does not necessarily mean that they never intend the agreement to be effective and binding. The proper conclusion to draw may be that they agreed to vary their agreement and that they have become bound by the agreement as varied (see for example *Garnac Grain Co Inc v. HMF Faure & Fairclough Ltd* [1966] 1 QB 650 at 683-684 per Diplock LJ, which was cited by Mr Price).

Fifth, the intention must be a common intention (see *Snook*). ..”

And at page 234 Arden LJ stated:

“I have already noted that it is an established requirement of a sham transaction that the parties should have the common intention that it should not take effect according to its tenor and in addition that a false impression should be given to third parties. But this point raises one of the issues of law that has arisen in this case: common to whom? Mr Price submits that the intention must be common to all the parties to a document saved in very exceptional circumstances, which he does not define and which he submits it is not appropriate to define since they were not applicable in this case. Thus, on his submission, all the parties had to have a common intention, and hence the 1984 deed was incapable on the facts as found by the commissioners of being a sham. He refers to this as the ‘all or nothing’ principle. Mr Vallance submits that this is not a necessary requirement of a sham, and does not apply where (as here) the document implemented more than one transaction. In principle I accept Mr Vallance’s submission. In *Snook* Diplock LJ was concerned with the situation where the document implemented a single transaction, and his words must be read in the context of the case before him. In any event, the effect of Mr Price’s submission is that the court will be precluded from finding that a document is a sham because it includes an additional provision which is intended to be effective. This might deprive the doctrine of sham of any operation in a situation which is logically indistinguishable from the situation where the doctrine of sham

already applies. In my judgment, the law does not require that in every situation every party to the act or document should be a party to the sham. I accordingly reject Mr Price's submission save that I accept that the case where a document is properly held to be only in part a sham will be the exception rather than the rule, and will occur only where the document reflects a transaction divisible into separate parts."

3. RE Esteem Settlement, (otherwise known as the Grupo Torras case)

The case of Re: Esteem Settlement, Grupo Torras SA & Ors v. Al Sabah & Ors [2003] JLR 188 was a decision of the Royal Court of Jersey handed down on 13th June 2003. This litigation arose out of a fraud perpetrated by Sheikh Fahad Mohammed al Sabah and others on Grupo Torras SA ("GT"), which was a company owned by the Kuwait Investment Office in sum of US\$430 million. Sheikh Fahad's personal share of the fraud was US\$120million. GT obtained judgment for US\$800million against Sheikh Fahad in the English High Court which was enforceable in Jersey under reciprocal enforcement laws.

Sheikh Fahad had no personal assets against which the judgement could be enforced and Sheikh Fahad was declared bankrupt in the Bahamas where he is currently residing.

Sheikh Fahad set up a number of trusts in various jurisdictions one of which was the Esteem Settlement ("the Settlement") the trustee of which was Abacus (CI) Limited and which was one of main parties to the litigation. The Settlement was established in 1981. The fraud on GT was carried out between 1988 & 1992. Prior to the fraud the Sheikh contributed personal assets to the Settlement. Subsequently the proceeds of the fraud were transferred to the Settlement. In previous judgements the transactions transferring assets derived directly from the fraud to the Settlement were set aside. The remaining assets in the Settlement for purposes of this particular case were untainted by the fraud.

Various interesting claims were brought by GT against the Sheikh such as, the remaining Settlement assets should be subject to a remedial constructive trust, that the Settlement was a sham with the assets held on bare trust for the Sheikh and that the veil of the Settlement should be lifted.

As to the sham argument raised in the case, the following points are worthy of note.

The law

The previous English and Jersey authorities raising the legal argument of a sham were reviewed in great detail by Deputy Bailiff Birt.

Much argument concerning the sham issue focused on the legal issue as to whether it is necessary for both the settlor and the trustees of a settlement to be parties to a sham or whether it is possible to have a unilateral sham. Having reviewed all the main authorities on the issue including *Snook* and *Hitch v Stone*, *Rahman* as well as *Chase Manhattan Equities Ltd v Goodman* (1991) BCC 308 the Deputy Bailiff stated (para 53):

“In our judgment, in order for a trust to be a sham, both settlor and trustee must intend that the true arrangement is otherwise than as set out in the trust deed”

The Deputy Bailiff also dismissed argument that a settlement established by unilateral mistake may be set aside as per *Gibbon v. Mitchell* (1990) 3 All ER 338 and that by analogy the same should apply in relation to setting aside a settlement based on the argument of a unilateral sham. The reason being that in the case of a unilateral sham the settlor would have deliberately misled and deceived the trustees and the beneficiaries (para 53(x)).

The Deputy Bailiff also considered in some detail the nature of the parties’ intention that the situation should be otherwise than as set out in the trust deed in order to find a sham

The Deputy Bailiff referred to *Midland Bank v Wyatt* and apparently agreed with the dicta of Young QC, that if one party goes along with shammer not either knowing or caring what he is signing (i.e. being reckless) then that would constitute sufficient intention to create a sham.

“It follows that in our judgment, in order to succeed the plaintiffs will need to establish that, as well as Sheikh Fahad, Abacus intended that the assets would be held upon terms otherwise than as set out in the trust deed or alternatively went along with Sheikh Fahad’s intention to that effect without knowing or caring what it had signed and that both parties intended to give a false impression of the position to third parties or the Court.” (para 59)

It was accepted by both parties that even where the original settlement is valid, if an asset is subsequently transferred to the settlement on the basis that the intention of the parties is that the asset is not be held on the trusts of the settlement. Then the transfer of the assets into the settlement will be held to be a sham.

The facts

As to factual background concerning the Settlement for the purposes of the sham argument, the following facts are pertinent.

The Settlement was a Jersey law discretionary settlement. The beneficiaries of the Settlement were Sheikh Fahad, his wife Barbara & son Mishal & any children or remoter issue of settlor & any spouse of Mishal. At relevant time only Sheikh Fahad, Barbara and Mishal were in existence (para 16).

There was an unremarkable letter of wishes stating that the purpose of the settlement was to preserve the trust fund for the benefit of his son Mishal. The letter of wishes contained the usual caveat “without attempting in any way to fetter the exercise by you of the powers & discretions conferred on you etc”.

The focus on the assets in the Settlement was on property in Dulwich which was not originally intended to be transferred to the Settlement. Dulwich property was intended to be owned by a company over which Sheikh Fahad would have considerable control, the intention being to shield the Sheikh’s assets from CGT. The Sheikh was advised by his lawyers, Stephenson Harwood, to transfer Dulwich property into Settlement. The Dulwich property was ultimately held by an underlying company which was wholly owned by the Settlement.

The findings of Court were that Abacus (the trustees of the Settlement) intended to act as proper & independent trustees in accordance with provisions of trust deed. Contact between Abacus and Sheikh Fahad was virtually non-existent until 1994 and all prior contact had been through Stephenson Harwood.

The Dulwich Property was a home where all the beneficiaries of the Settlement had lived. It was recorded by Abacus that the beneficiaries should be entitled to live in property rent free. In relation to refurbishment of the Dulwich property, Abacus had requested clarification on a number of matters (para 312/313). Although Abacus considered the wishes of Sheikh and his wife the Court did not find that this was a rubber stamping exercise in relation to Dulwich property (para 317) and the same applied in relation to other properties acquired by Settlement (para 372/373).

Only good evidence against the Sheikh of a shamming intention was a file note of Stephenson Harwood, suggesting that Sheikh Fahad would have control over the trustees but the Court's finding was that this was only a reference to the Sheikh's power to remove Abacus as trustees (para 204).

On issue of control of trust assets the Court found that Abacus considered each of the Sheikh's requests in good faith (para 510). The Court accepted that Abacus paid close attention to the views of Sheikh Fahad but stated that it was perfectly in order to do so.

The findings

The Deputy Bailiff stated that the Court was entitled to look to ongoing conduct when establishing the original intentions of the parties (para 194(vi)). The Court found that Abacus did not have the intention that the Settlement should be a sham at time the Settlement was established or when the Dulwich property was effectively transferred into Settlement. Hence the Plaintiffs' argument that the Settlement was a sham failed (para 196).

For good measure the Court stated that even if they were wrong that both parties had to have the shamming intention (i.e. if it were possible to have a unilateral sham) that Sheikh Fahad did not have a shamming intention in any event.

4. The case of Shalson v Russo

Peter Shalson and Ors v. Onofrio Russo & Ors [2003] EWHC 1637

This was a first instance case before Mr Justice Rimer and primarily concerned a fraud perpetrated by an Italian National, Mr Russo, against various persons and their associated companies of which a Mr Shalson and a Mr Mimran were notable parties. Various claims had been bought by Mr Shalson and Mr Mimran including tracing claims and that a particular settlement established by Mr Russo known as the ‘Brookscastle settlement’ was a sham. The factual background to the case was complicated and involved various offshore companies and international business deals over an extended period from 1995 to 2001. One of the most prominent claims involved tracing into a motor yacht “the Mosaique” which was part of a joint venture between Mr Russo and Mr Shalson at a cost of US\$14.5million.

The Brookscastle settlement (“the Settlement”) was a Jersey settlement created by a deed dated 4th March 1999. The deed was executed solely by Cantrust (CI) Limited which was a Jersey company who were the appointed trustees of the Settlement under the Deed. The Settlement deed resettled on wide discretionary trusts as to capital and income the assets held in 3 other trusts previously established by Mr Russo.

The beneficiaries of Settlement were the issue of Mr Russo’s parents which included Mr Russo and his 2 brothers and their various children. The protectors of the Settlement were Mr Russo’s two brothers. The Trustees of the Settlement had the power to add and remove beneficiaries. The value of resettled assets was US\$39million. The claim was bought on the basis that the true settlor and beneficiary of the Settlement was Mr Russo and that on the facts the Settlement was a sham.

As to the law concerning the sham argument, Mr Justice Rimer cited again Diplock LJ’s comments in *Snook* and referred to both *Hitch v. Stone* and also to *Re Esteem* (although the judgement in *Re Esteem* was only referred to Rimer J by counsel after he had reserved judgment). Rimer J concluded (at para 188).

“After a careful consideration of the authorities the Royal Court of Jersey held in *Abacus (CI) Limited and others v. Sheikh Fahad Mohammed al Sabah and others* 13th June 2003, unreported ... that the like principle applies to an allegedly sham settlement: both the settlor and the trustee must intend the settlement to be a sham, and they rejected the proposition that all that counts is the settlor’s intention.”

And then in paragraph 190 he states:

“Despite Mr Smith’s 12 page submissions to the contrary effect, I respectfully regard the approach adopted by the Royal Court in the *Abacus* case as correct. It is not only squarely in line with the guidance given by the Court of Appeal in *Snook* and *Hitch*, it also appears to me to be correct in principle. The settlor may have an unspoken intention that the assets are in fact to be treated as his own and that the trustee will accede to his every request on demand. But unless that intention is from the outset shared by the trustee (or later becomes so shared), I fail to see how the settlement can be regarded as a sham.”

Cantrust was the sole party to Settlement deed and the deed was executed in exercise of Cantrust's powers under the prior trusts. It was not argued before the Court that the prior trusts were shams. The evidence before the Court was that Cantrust was in no sense a knowing party to the allegedly sham nature of the Settlement. Hence the Court found that the sham argument failed.

A wider argument was raised by Mr Mimran that Mr Russo always dealt with the assets of the Settlement as his own and thus the Settlement was a sham. Rimmer J found that although some evidence of this existed, there was also considerable evidence that Cantrust properly considered the exercise of its powers under the trust instrument and that they also took Mr Russo to task on some of his activities involving assets of the Settlement.

At para 217 Rimer J stated:

“The evidence overall satisfies me that Cantrust was doing its best, if not always very cleverly, to control the affairs of the settlement, albeit that Mr Russo was often several steps ahead of the game, resulting sometimes in Cantrust having to sometimes catch up with what he had been doing . I find that, whatever Mr Russo’s intentions with regard to the settlement, Cantrust executed the document that created it with the honest belief and intention that it was creating a valid settlement, and was at no time a party to any understanding with Mr Russo that the settlement was merely warehousing its assets. I decline to find that that the settlement was a sham or that it was appropriate to pierce the settlement’s veil and declare the assets duly vested in it in fact belong exclusively to Mr Russo. I dismiss the claim against Cantrust.”

5. Consequences of a finding that a trust is a sham and the interrelation with other forms of relief

In the case where the whole of the trust is found to be a sham then the trust will generally be regarded as void but not for all purposes (see the *dicta* of Young QC in *Midland Bank v.*

Wyatt page 707, Neuberger J in National Westminster Bank plc v Jones [2001] BCLC 98 paras 36 to 46, 59, 60 and 68 and Charles J in Carman v Yates (Lawtel 8th November 2004) para 219 and 220. Rather where there is a sham:

- (i) the parties to the trust deed will not be able to rely on the trust deed as representing the true position as to the rights between the parties and the Court can ignore the trust deed in determining what those rights are, and
- (ii) as against an innocent third party, the parties to the sham may not rely upon the trust deed as being void so as to disadvantage the innocent third party.

As to the legal status of the trust assets upon a finding that a trust is a sham this will depend upon the facts in each case. One likely scenario is where the settlor has sought to conceal personal assets from his creditors by placing them in a trust which is subsequently found to be a sham. In this eventuality it is likely that the assets will be found to be held on a resulting trust for the settlor and hence be available to creditors of the settlor (see *Midland Bank v. Wyatt* although no declaration to this effect was sought in this particular case).

It may of course be that assets in the trust have derived from a third party other than settlor who has been defrauded (as alleged in *Re Esteem*) such that a constructive trust would be imposed on persons holding the assets for benefit of persons defrauded. The assets may or may not be held by the trustees in this scenario and therefore it is likely that a constructive trust would only be imposed upon the trustees in these circumstances where the trust assets remain under the control of the trustees.

Where the trust assets have derived from a defrauded third party but the trust assets are not in the hands of the trustee and the assets are found to have been improperly dissipated by the settlor, there is the possibility of a claim of dishonest assistance being brought against the trustee. Such a claim, would, however, depend upon the trustees' state of knowledge concerning the origins of the assets. See for example – *Twinsectra v. Yardley* [2002] 2 WLR 802 and *Royal Brunei Airlines v. Tan* [1995] 2 AC 378.

Alternatively where the trust assets remain in the hands of the trustee, the trustee could find themselves the subject of a tracing claim if the trust assets are found to be the property of a third party but have been mixed with the personal assets of the trustee or a fourth party. See for instance the dicta of Lord Millett in *Foskett v. McKeown* [2000] 2 WLR 1299 @ 1322.

The upshot of the above comments is that, a claim for a declaration that a trust is a sham is unlikely to be brought on its own. It is likely to be coupled with alternative recovery claim, the nature of which depends upon the particular facts of the case and the party bringing the claim.

In *Midland Bank v. Wyatt* for example the claim that a trust deed was a sham was coupled with a claim for an order under s.423 Insolvency Act 1986 on basis that the execution of the trust deed was a transaction made at an undervalue with an intention to defeat creditors. It is noteworthy that in *Wyatt*, Young QC stated that the question he had to decide was ‘whether and how far the provisions of s.423 of the IA covers the voluntary disposition of assets to avoid future and unknown creditors’. Young QC found that although Wyatt was of sound financial standing when he executed the deed, his concerns regarding the potential hazards of his future business were sufficient to fall within the remit of s.423.

The interrelation between a claim based upon sham and a claim under sections 423 and 339 of the IA 1986 is developed in considerable detail by Charles J in *Carman v Yates (Lawtel 8th November 2004)* (see in particular paras 168 to 178 of the judgement). Charles J highlights the potential advantages of bringing a claim under the statutory provisions rather than on the basis of a sham where the statutory provisions apply. In particular he sights the following:

- (i) Providing the transaction can be shown to be at an undervalue and made within the defined period (in the case of s.339) or with the necessary intention to defeat the defendant’s creditors (in the case of s.423) there is no need to prove any shamming intention on the part of the parties to document or action in question.
- (ii) The provisions for relief in s. 339 and s.423 are broadly defined and give the Court the power to restore the position to that which would have existed had the defendant not entered in to the transaction in question. Unlike in the case of a sham, this potentially avoids the Court having to deal with complicated issues of law and equity in assessing the appropriate to relief to grant to the claimant.

Other cases concerning sham transactions have been brought by Inland Revenue in relation to assessment of tax, *Hitch v. Stone*, for example was an appeal from decision of the Special

Commissioners under s.56 of the Taxes Management Act 1970 relating to the Special Commissioners assessment of the taxpayers liability to Capital Gains Tax. Equally well the case of *R v. Allen* [1999] STC 846 concerned an appeal against conviction on the grounds of cheating the Revenue out of corporation tax and income tax under s.145 and s.154 of the Income and Corporation Taxes Act 1988. One aspect of the case concerned monies held in offshore trusts over which it was alleged the deceased (Mr Allen) had control and that the trusts were thus a sham.

By contrast the cases of *Re Esteem* and *Shalson v Russo* , in addition to bringing claims for a declaration that the trusts in question were shams, also included claims for a remedial constructive trust and dishonest assistance in breach of trust respectively.

6. Revenue considerations

The Revenue's involvement in proceedings where a sham trust argument is alleged, could be from many sources. Either the Revenue will be a bystander in proceedings brought by a third party or the Revenue may bring a claim against the settlor themselves.

If the Revenue is involved in the claim against the settlor in relation to tax avoidance the following provisions may be relevant, although this is in no way intended to be a comprehensive guide to the potential taxation issues that might arise in a case where a sham trust is alleged.

Income Tax

As far as income tax is concerned, the anti-avoidance provisions for a settlement are comprised in sections 660A to 682A of the ICTA 1988. Essentially income deriving from any 'settlement' is treated as income of settlor, unless the settlor has no interest in the property, see section 660A ICTA 1988. However 'settlement' is defined as 'any disposition, trust covenant, agreement or arrangement or transfer of assets'. Hence the Revenue could potentially rely on this provision for the recovery of income from assets held in a trust which have generated income and which has subsequently found to be a sham.

Where the settlement is based offshore and the settlor is ordinarily resident in the UK, the anti-avoidance provisions in sections 739 and 740 ICTA 1988 may also be relevant.

CGT

The anti-avoidance provisions concerning CGT insofar as UK resident trusts are concerned are set out in section 77 TCGA 1992 and apply to the 'trustees of a settlement'. If there is no settlement (because of finding that the trust was a sham) then the section will probably not apply. However, subject to issues of hold-over relief, where a disposal of assets is made into a trust, it is quite possible that this will attract CGT. In the scenario where the trust is subsequently found to be a sham and the trust assets held on resulting trust for the settlor, it seems arguable that there was actually no disposal for CGT purposes and that hence the settlor was entitled to a tax credit. On the downside however, subsequent dispositions by trustees of the trust, prior to the finding that the trust was a sham, might subsequently be referable to the settlor, hence creating a charge to CGT on the settlor personally.

In a like manner to section 77, section 86 TCGA 1992 may be relevant in relation to gains realised in offshore trusts.

IHT

As far as IHT is concerned, with inter vivos settlement into, say, a discretionary trust where IHT is chargeable on the disposal, there again could be a potential case for claiming a tax credit where the trust assets are found to be held on a resulting trust for the settlor, because no disposal had actually been made, see sections 235 and 241 IHTA 1984. Where, however, disposal was into a trust which qualified as a PET, then there will be no opportunity for an IHT credit.

Stamp duty/ Stamp duty land tax

Where stamp duty or stamp duty land tax has been paid in relation to a disposition into a trust which is subsequently found to be a sham, then where the trust assets are held on a resulting trust for the settlor, there is a possibility of a credit of this tax to the settlor.

General tax cases which may be of relevance

W.T. Ramsay v IRC [1982] AC 300. This case gave rise to what is commonly known as the 'Ramsay Principle'. The case essentially stated that the approach of the Courts in relation to

tax avoidance schemes was to look through the various transactions comprised in the scheme for the purposes of assessing tax and that the relevant tax assessment should be based on the real underlying transaction.

IRC v McGuckian [1997] 1 WLR 991, which concerned consideration of what is now the anti-avoidance provisions of section 730 and s739 of ICTA 1998 and in which the scope of the Ramsay Principle was discussed further

See also Macniven v Westmoreland [1998] STC 1131 and the recent decision of the House of Lords in Barclays Mercantile Business Finance v Mawson [2004] UKHL 51. It is now apparent from the decision in Mawson that the scope of the Ramsay Principle is severely limited and that the Revenue can no longer rely on this doctrine as a kind of ‘free standing’ principal to assist them in tax recovery.

7. The law on sham trusts in a nutshell

- (a) In order for a trust to be found to be a sham, both of the parties to the establishment of the trust (that is to say the settlor and the trustees in the usual case) must intend not to act on the terms of the trust deed. Alternatively in the case where one party intends not to act on the terms of the trust deed, the other party must at least be prepared to go along with the intentions of the shammer neither knowing or caring about what they are signing or the transactions they are carrying out.
- (b) It is the subjective intention of the parties to the trust deed that is important not their objective intention in assessing whether the necessary shamming intention of the parties exists.
- (c) The fact that a trust deed reserves extensive powers to the settlor or to parties controlled by the settlor, does not of itself mean that a trust will be held to be a sham.
- (d) The activities of the parties to the trust deed after the execution of a trust deed may be used as evidence of the parties’ intentions at the time of the execution of the trust deed and/or subsequent to the execution of the trust deed.

- (e) A trust that is not a sham upon its execution may subsequently become a sham if the necessary intentions of the parties can be proved. Alternatively a particular transaction concerning a trust may be found to be a sham, providing the necessary intentions are proved, notwithstanding that the trust itself is not a sham. These situations are, however, likely to be rare.
- (f) In a claim alleging a sham, the burden of proof lies upon the person alleging the sham and the standard of proof in a civil claim is the balance of probabilities.
- (g) In the case where the whole of the trust is found to be a sham (as opposed to a particular transaction under the trust) then the trust itself will generally be regarded as void. However, where an innocent third party is involved the trust may not be regarded as void and it will be for the Court to define the rights of the parties involved depending upon the facts of the particular case.
- (h) In the case of UK resident trust in particular, serious consideration should always be given as to whether sections 238, 339 or 423 of the Insolvency Act 1986 (relief from transactions at an undervalue) may apply.

8. The practical application of the law concerning sham trusts with regard to the administration of trusts

If you are advising trustees when there is a whiff of a potential sham trust claim brewing, then advise the trustees to ensure that they have control over the trust assets. This at least means that the trust assets may be available to satisfy (at least in part) any monetary judgement which is enforceable against the trustees.

Trustees should keep regular and proper records concerning the administration of the trusts. Such records are important in defending a sham argument as they can provide proof that the trust was being properly administered.

Occasionally refusing to act on settlor's wishes or at least questioning the settlor with regard to his requests concerning the trust assets are good indicators of a non-shamming intention on the part of the trustees.

Where possible trustees should get involved with any transactions which are being led by the settlor. The trustees should ask questions and not stand passively by, even if all appears to be well.

Where appropriate trustees should invite the views of the other beneficiaries not just the settlor.

Once the trust has been established, the trustees should not refer to the settlor as 'the client' in the trust records. In many of the reported cases the Court has picked up on the fact that the trustees' records refer to the settlor as 'the client'. This looks particularly bad when the settlor is also a beneficiary. In a discretionary trust, for example, referring to one particular beneficiary as 'the client' and the other beneficiaries by name hardly indicates a balanced view on the trustees' part as the importance of the different beneficiaries.

The reservation of wide powers to the settlor in the trust deed (particularly powers to appoint capital and income and investment powers) will not of themselves be sufficient to give rise to the argument that a trust is a sham. However, obviously the more powers that are reserved to the settlor (or perhaps to third parties who might be under the control of the settlor) the more credibility there will be to a sham argument because of the reduced nature of the trustee's role.

In summary, providing trustees act within the terms of the trust and are on top of the administration of the trust, the settlor and the trustees should be able to resist any argument that a trust is a sham. However, such acts may not be sufficient to prevent a trust from being set-aside where a claim for such relief is brought under the provisions of the Insolvency Act 1986 (as referred to above), on the basis the establishment of the trust or the transfer of property into the trust was a transaction at an undervalue.

[END]