THE AVER ADVISORY

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TRUST RESIDENCY

Court adopts new residency determination based on central management and control of trust

Garron Family Trust et al. v. The Queen, 2009 TCC 450 (Tax Court of Canada, Sept. 10, 2009)

In September 2009, the Tax Court of Canada released two decisions affecting the use of trusts as tax planning vehicles—the *Garron Family Trust* decision and the *Antle Spousal Trust* decision.

Both cases involved offshore trusts that had trustees resident in Barbados and beneficiaries resident in Canada. In both cases, capital gains from the disposition of assets would be realized by the trusts in Barbados and not subject to tax. An exemption from Canadian tax liability would be claimed under the *Canada-Barbados Tax Treaty*. In both cases, the Court held that the arrangements failed.

Garron Family Trust. The Court shifted away from the generally accepted and long-standing common law basis for determining trust residency based on trustee residence. Instead, the court adopted a residency determination based on the location of the central management and control of the trust.

Facts. Mr. Garron owned a profitable Canadian company. In 1998, the share structure of the company was reorganized. An individual resident in the Caribbean island of St. Vincent set up two trusts with Garron as one of the beneficiaries. The sole trustee of the trusts was a resident in Barbados. In 2000, the business was sold to a private equity fund, which purchased the shares owned by the trusts. The transaction resulted in capital gains of over $450 million.

After paying 25% in taxes, the trusts sought a refund on the basis of a tax exemption under the *Canada-Barbados Tax Treaty*, which states that capital gains may only be taxed in the country of residence. The trusts claimed that they were residents of Barbados whereas the Ministry of Revenue held that the trusts were residents of Canada.

Decision. In determining that the trusts were resident in Canada, the court considered many factors including:

- The purpose of the trust.
- Garron's ability to replace the trustee.
- An internal memo setting out the intention of the parties.
- The lack of credible witnesses involved in the management of the trust.
- The lack of the trustee's demonstrated expertise in managing trust assets.

Based on these factors, the court found that the trustee was selected on behalf of the beneficiaries to provide administrative services. There was little evidence that the trustee had any involvement in the affairs of the trusts, other than in the execution of agreements and in administration, accounting and tax matters.

The court found that the role of the trustee was not expected to extend beyond administrative services to encompass decision-making responsibility. As such, management and control—and, therefore, residency—was not established in the Barbados trust. ■

TRUST VALIDITY

Tax planning arrangement fails due to invalid formation of trust

Antle et al. v. The Queen, 2009 TCC 465 (Tax Court of Canada, Sept. 18, 2009)

Antle Spousal Trust. In 1998, Mr. Antle bought shares in a private corporation through another company. In 1999, he sold his shares to a third party. To avoid taxes on the gain, he transferred the shares to a trust. The trust sold the shares to his wife at fair market value in exchange for a promissory note. His wife then sold the shares to a third party and used the proceeds to pay the trust. The trust was then dissolved. This strategy resulted in no tax on capital gains.

Decision. In finding that the trust was invalid, the court noted that a trust must have three certainties: intention, subject matter, and object. There must be a complete transfer of subject property to the trust. The court concluded that the trust was not validly constituted as it did not meet the certainty of intention and of subject matter.

The court held that the intention was not to settle the trust, but to process a transaction. The court also found that Antle retained an interest when disposing of the shares. Because the full interest was not transferred to the trustee, the trust lacked the certainty of subject matter. ■

TRUSTEE DISCRETION

Delaware decision highlights duty of trustee to consider interests of all beneficiaries

Merrill Lynch Trust Company, FSB, v. Mary F.C. Campbell et al., C.A. 1803-VCN, V.C. Noble (Del. Ch. Sept. 2, 2009) (Mem. Op.)

It is often the case that the current beneficiary of a trust will apply pressure on the trustee to adopt a certain investment strategy or to remain invested in one or more designated stocks.

A recent Delaware Court of Chancery decision demonstrates that a trustee has a fiduciary duty to consider the interests of all beneficiaries when making investment decisions.

The court held that abandoning future beneficiaries of the trust and focusing exclusively on the needs of the life beneficiary carries with it the potential for a breach of the trustee's fiduciary duties.

Facts: When Mary Campbell was 74 years old, she was persuaded by a Merrill Lynch broker to establish a trust for her own benefit, with Merrill Lynch Trust Company serving as trustee.

The trust was to pay 10% of the net fair market value of the trust's assets to Campbell annually during her lifetime, then to her husband if he survived her, then to the couple's three children, upon whose death the trust assets would be distributed to five charities.

As Campbell's financial needs increased, she requested larger distributions from the trustee. In response to Campbell's request, the trustee shifted its investment strategy towards greater growth and a higher percentage of equities. Unfortunately, the trust's high equity exposure coincided with a general decline in the stock market, resulting in substantial losses in the value of the trust assets.

A frustrated Campbell then sought to replace the trustee, while the trustee brought an action seeking judicial approval of its conduct. Campbell filed a counterclaim criticising the trustee's decision to increase the equity mix of the trust. She alleged that the trustee's investment decisions were a breach of its fiduciary duties.

Decision. In reviewing the trustee's investment strategy, the court took note of the trust's unusual structure; namely, the competing pressures to make large distributions to the current beneficiary, while preserving the trust assets over the long term—the trust was projected to last approximately 48 to 51 years.

The court held that such competing pressures should not be held against the trustee because the trustee did not participate in the decisions surrounding the formation of the trust.

The court emphasized that the trustee was constrained by the terms of the trust, which appeared to give the trustee few good options in setting trust investment strategy.

The court held that the trustee "cannot be held liable for its good faith reliance on the express provisions of the trust agreement," adding that although reasonable advisors might disagree with the trustee's investment strategy, such disagreement did not render the trustee's choices unreasonable under the circumstances.

The court also stated that "merely carrying a high equity mix (even approaching 100%) instead of investing in bonds or in cash is not, on its own, an actionable breach of the duty to diversify, even if it might ordinarily prove difficult to justify; a trustee's duties are contextual, and there may be situations, perhaps rare, where diversification is neither practicable nor desirable. There is no set formula for diversification."

Commentary. The court's analysis in this case highlights the important need for trustees to establish a record that supports their due diligence and independent decision-making process when exercising investment discretion. ■

TRUSTEE SKILL

Court reaffirms importance of skillful trust management

Regent Trust Company Ltd., (2009) JRC 117 (Royal Court of Jersey)

The importance of trusts being managed and administered by professionals with appropriate skills has long been recognised by the courts.

The Royal Court of Jersey recently had the opportunity to reaffirm the importance of skillful trust management. In Regent Trust Company Limited, the trustee had been charging fees on the basis of time spent at an hourly rate since the early 1970s.

Following a restructuring of the trust in 2008, the trustee noted that the charging clause stated that:

> The trustee could only be remunerated in accordance with the schedule and fees in force at the date of the trustee's appointment.

Consequently, it was arguable that the trustee was restricted to charging its 1971 hourly rate. The trustee sought direction from the court.

The Royal Court directed that the trustee could retain the fees that it had charged. It also authorised any successor trustee to collect its fees in accordance with the successor trustee's schedule of fees in place from time to time. The court added that it was unrealistic to suggest that professional trustees would provide their services without funding, or that their fees would not increase with market rates. ■

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PROTECTOR OF THE TRUST

Court issues guidance to trust protectors on how to manage conflicts of interest

Representation of Centre Trustees, [2009] JRC 109 (Royal Court of Jersey)

The fundamental duty of a trust protector is, not surprisingly, to protect the terms of the trust and the interests of the trust's beneficiaries. On occasion, however, the protector's personal interests may conflict with such duties.

In *Representation of Centre Trustees*, the Royal Court of Jersey affirmed that when a protector exercises his powers, such powers must always be exercised for the benefit of the trust beneficiaries.

Facts. Around 1997, Wilfred Pabst and Herman Van Rooyen agreed to participate in the development of certain South African mining interests. They each established a trust for this purpose.

Pabst was appointed protector of the Van Rooyen (VR) trust. In this capacity, Pabst enjoyed extensive powers including, for example:

- Powers of approval in respect of trustee appointments.
- Powers to add and exclude beneficiaries.
- Powers to make transfers of funds to another settlement.

In 2000, some of the mining interests were sold and each of the trusts stood to share equally in these proceeds—about $46 million. The VR trust, for which Pabst was protector, received about $6 million less than the trust in which Pabst had a beneficiary interest.

The facts revealed that Pabst had been involved in numerous decisions to advance his personal interests at the expense of the VR trust—for which he was protector—including:

- The inequitable distribution of the proceeds of sale to the prejudice of the VR trust.
- An offer by Pabst's trust to purchase the VR trust's interest at a substantial undervalue.
- A demand for the VR trust to return its share of the proceeds of sale.
- The appointment of an additional trustee to advance Pabst's claims.

Decision. The court ruled against Pabst and affirmed that the protector must exercise his powers in good faith and clearly not for his own interest. Decisions of a protector must be made free of any private interest or competing duty.

Commentary. The court went on to advise protectors on how to manage conflicts of interest. First, the protector must disclose the conflict to the trustee and the beneficiary.

Second, if it is in the interests of the beneficiaries for the protector to remain in office, the protector must honestly and reasonably believe that he can discharge his duties in the interests of the beneficiaries despite the conflict.

Finally, if the protector cannot justify the exercise of his powers, he must resign. If he fails to do so the trustee can apply to the court to have the protector removed. ■

CELEBRITY ESTATES

Standard estate planning structure preferred by British Royalty

When Prince Harry celebrated his 25th birthday in September last year, the occasion offered a glimpse into the estate planning preferences and choices made by Princess Diana.

Diana's estate was worth £21 million. More than £8 million was paid in inheritance tax, leaving almost £13 million to be split between Harry and his brother, Prince William.

Fortunately, Diana's estate plan involved the use of a trust, as neither of her sons was of age at the time of her death. Had she left the money directly to her sons by will, then Prince Charles would have needed to be appointed guardian of the princes' estates.

Princess Diana's trust documents contained standard clauses allowing her to control her children's inheritance in the event of premature death. These standard provisions included, for example, terms to the effect that:

- The money remains whole until the youngest child reaches a minimum age (i.e. 25). This ensures there will be enough money in aggregate to provide for all of the children.
- Once the youngest child reaches age 25, the money is split into separate shares.
- The separate shares are still held in trust for each child. The trustee can then use each share for the respective beneficiary's benefit.
- Upon reaching age 25, the beneficiary only receives access to the income, comprising the interest and dividends attributable to the stocks, bonds, cash and other property that make up his trust.
- Upon reaching age 30, the beneficiary receives full access to the trust assets—income and principal.

Although she was royalty, Princess Diana's estate plan was quite standard. ■