

KEEPING IN TOUCH

ALTER EGO TRUSTS AND JOINT SPOUSAL OR COMMON-LAW PARTNER TRUSTS

INTRODUCTION

Among the legal tools to be considered for use in establishing an estate plan are the alter ego trust and joint spousal or common-law partner trust arrangements which qualify for the application of special rules under the *Income Tax Act* (Canada) (the "ITA") and can be advantageous in particular circumstances.

A common reason for an individual to establish either type of trust is to prevent the application of estate administration tax on the death of the individual to the assets held by the trust which would otherwise be administered following death pursuant to the deceased's will upon the will being submitted to the court for probate. There are a number of other advantages that can be achieved, but there are also potential disadvantages which should be taken into account before a decision is made whether to establish such a trust.

QUALIFYING REQUIREMENTS

An alter ego trust is a trust established by an individual during the individual's lifetime for the individual's own benefit and for the benefit of those whom the individual wishes to benefit following his or her death. A joint spousal or common-law partner trust (a "joint partner trust") is similar to an alter ego trust but is established either by an individual for the joint benefit of the individual and his or her spouse or common-law partner and those whom the individual wishes to benefit following the death of the last to die of the individual and his or her spouse or common-law partner, or by both spouses or common-law partners jointly for their own benefit during their lifetimes and for the

benefit of those they wish to benefit following the death of the last of them to die.

In order for a trust to qualify as an alter ego trust, the person contributing the property to the trust (the "Settlor") must be resident in Canada, must be 65 years of age or older and must be entitled to receive all of the income of the trust during his or her lifetime, and no person other than the Settlor can receive or obtain the use of any income or capital of the trust prior to the death of the Settlor. In the case of a joint partner trust, the Settlor must be resident in Canada and be 65 years of age or older, and the Settlor and/or his or her spouse or common-law partner must be entitled to receive all of the income of the trust prior to the death of the survivor of them and no person other than the Settlor and/or his or her spouse or common-law partner can receive or obtain the use of any of the income or capital of the trust before they both have died.

ATTRIBUTES

The basic attributes of a qualifying alter ego trust or joint partner trust may be summarized as follows:

1. Property may be contributed to the trust on a tax deferred roll-over basis so that the person contributing the property to the trust is deemed to dispose of the property at that person's tax cost with the result that no accrued capital gain is deemed to be realized and the trust is deemed to acquire the property at the same cost. However, the Settlor can elect not to have the roll-over rules apply with the result that the property would be deemed to be disposed of by the Settlor at fair market value and any accrued capital gains would be deemed to be realized and be subject to immediate taxation. The Settlor might choose to make this

election where capital losses on other properties are available to offset the gain and eliminate the resulting capital gains tax. This would be a particularly useful election where those losses might not otherwise be usable.

2. Upon the death of the Settlor of the alter ego trust or, in the case of the joint partner trust on the death of the survivor of the Settlor and his or her spouse or partner, the property of the trust is deemed at that time to be disposed of at fair market value and all capital gains accrued up to that time are deemed to be realized and are subject to the imposition of capital gains tax. If the property of the trust is distributed at that time to the ultimate capital beneficiaries, they are deemed to receive the property at that fair market value. This differs from the tax treatment of property distributed to capital beneficiaries of other trusts which generally qualify for tax deferred roll-over treatment at the time of distribution.

3. The 21 year deemed disposition rule, pursuant to which most trusts are deemed to dispose of and re-acquire their capital properties at fair market value every 21 years so that accrued capital gains are deemed to be realized and are taxed, thereby preventing the taxation of capital gains being deferred indefinitely, does not apply to alter ego and joint partner trusts until the death of the Settlor, or the death of the survivor of the Settlor and his or her spouse or partner in the case of a joint partner trust. After that time, the 21 year deemed disposition rule commences to apply to any alter ego or joint partner trust that continues under the terms of the trust document and, in addition, any subsequent distributions of capital property to beneficiaries can be carried out on a tax deferred roll-over basis.

ADVANTAGES

The primary use of an alter ego or joint partner trust is to replace a will as the means for establishing how the property contributed to the trust is to be distributed following the Settlor's death among the beneficiaries designated by the Settlor. The availability of alter ego and joint partner trusts for use in place of a will results in a number of potential advantages including the following:

1. A trust is not subject to probate, so where the nature of the property would require probate if dealt with by will, establishing the trust can avoid the imposition of estate administration tax. The tax saving can be

significant where property with substantial value is distributed pursuant to the terms of an alter ego or joint partner trust rather than pursuant to a will which is submitted to the court for probate. Estate Administration tax is imposed at the rate of 0.5% of the value of estate assets up to \$50,000.00 and at the rate of 1.5% of the value of estate assets in excess of \$50,000.00. By way of example, estate assets having a gross value of \$2,000,000.00 administered pursuant to a probated will would incur estate administration tax of \$29,500.00. This tax would not be incurred if those assets were dealt with pursuant to the terms of an alter ego or joint partner trust.

2. A will filed with the court for probate purposes becomes part of the public record with the result that there is a potential loss of confidentiality with respect to the assets and beneficiaries of the estate. The document establishing the alter ego or joint partner trust is not filed with the court and the property dealt with pursuant to the trust does not form part of the estate of the deceased so that a much greater level of privacy and confidentiality can be maintained.

3. Delays and complications in the administration of the property of the deceased can be minimized where the property is dealt with pursuant to the terms of an alter ego or joint partner trust where there is no change in the trustees on the death of the Settlor and where probate would be required if the assets were dealt with pursuant to a will.

4. There can be some measure of asset protection for property contributed to an alter ego or joint partner trust which would be enhanced to the extent that the interests of ultimate beneficiaries is clear, trustees other than the Settlor are appointed and the ability of the Settlor to direct or influence how the property of the trust is dealt with is restricted.

5. The establishment of an alter ego or joint partner trust can be a means of providing for the administration of the estate of the Settlor in the event that the Settlor suffers a mental incapacity that affects his or her ability to deal with his or her affairs where the trust document designates trustees, either initially or subsequently by substitution, other than the Settlor. Because the property of the trust is held in the names of the trustees, this can provide continuity of management of the trust property and avoid complications that can arise on the use of a continuing power of attorney for property.

6. Where a trust for the ultimate benefit of family members is planned to be established in any event, establishing the trust as an alter ego or joint partner trust can avoid the immediate deemed disposition at fair market value of the property transferred to the trust and the consequent immediate imposition of capital gains tax on accrued gains as well as avoid the application of the 21 year deemed disposition rule during the lifetime of the Settlor with the result that capital gains tax on accrued and accruing capital gains can be deferred until the death of the Settlor or, in the case of the joint partner trust, the death of the survivor of the Settlor and his or her spouse.

OTHER CONSIDERATIONS

For most purposes under the ITA there are basically two types of trusts being, firstly, *inter vivos* trusts which are trusts established during the lifetime of the Settlor and, secondly, testamentary trusts which are trusts established in consequence of the death of the Settlor. Alter ego and joint partner trusts are *inter vivos* trusts subject generally to all of the same rules of taxation under the ITA as are applicable to *inter vivos* trusts except only for the few special rules referred to above. As such, when considering the establishment of an alter ego or joint partner trust, care must be taken not to focus too narrowly on the particular rules applicable to alter ego and joint partner trusts, but to take into account broader considerations including the rules applicable to *inter vivos* trusts generally under the ITA as well as the practicalities of establishing and administering a trust. Matters to be considered include the following:

1. In order to ascertain the net benefit to be gained from establishing an alter ego or joint partner trust, the costs of establishing and maintaining the trust must be taken into account. Such costs would include the cost of having the trust agreement prepared and the cost of transferring and registering in the name of the trustees the property to be transferred to the trust, as well as the cost of maintaining complete and accurate books and records of the trust on an on-going basis. Additionally, under the ITA a trust is a separate person subject to taxation as an individual and is required to file income tax returns annually whether or not there is any income to declare so that there will be on-going costs incurred to have annual financial statements, income tax returns and information slips for distributions to and designations in respect of beneficiaries prepared

and filed.

2. In most cases the Settlor will wish to retain control of the trust and have the flexibility to withdraw capital as needed and to change beneficiary entitlements as circumstances change thereby retaining the ability to change plans in similar fashion as if they were set out in a will which a testator can amend at any time. In circumstances where the Settlor retains access to the capital of the trust or can change how the capital will ultimately be distributed, the attribution rules under the ITA will be applicable to cause all income of the trust to be taxed to the Settlor.

3. Where the Settlor is prepared to give up substantial control by appointing other trustees, making the trust irrevocable and foregoing the ability to encroach on capital or alter how the trust assets will be distributed following death, the attribution rules can be avoided. However, the graduated rates of tax applicable to individuals are not available to *inter vivos* trusts so that any income that is taxed in an alter ego or joint partner trust will be taxed at the highest marginal rate. (Note that elections can be made to have the income taxed in the trust notwithstanding that the Settlor or his or her spouse or partner must be entitled to receive the income.)

4. The income of testamentary trusts is taxed at the marginal rates applicable to individuals so that the benefit of the lower marginal rates is available to testamentary trusts. Where on-going trusts that continue after the death of the Settlor and/or the survivor of the Settlor and his or her spouse or partner are to be established, and this is to be done by means of an alter ego or joint partner trust, the benefit of the lower marginal rates that would be available for income realized in a testamentary trust established by will would necessarily be forgone.

5. In cases where the Settlor does not contribute all of his or her property to the alter ego or joint partner trust, there is a risk that there will be a mismatch of capital gains and losses on the death of the Settlor. For instance, if capital losses deemed to be incurred at the time of the death of the Settlor on property held outside the trust exceed the capital gains deemed to be realized on other assets also held outside the trust, the excess losses cannot be transferred to the trust to offset any capital gains deemed to have been realized on property held within the trust, thereby potentially

resulting in greater tax being incurred than would be the case if all of the assets were held under common ownership (either within or outside the trust) at the time of death.

6. Charitable donations cannot be made from an alter ego or joint partner trust during the lifetime of the Settlor. If it is desired to make provision for the trustees to make charitable gifts on or following the death of the Settlor or the survivor of the Settlor and his or her spouse or partner, there is a risk that there may not be sufficient trust income to absorb the gift particularly if the gift is large, and there is no provision allowing the unused part of the value of the gift to be carried back to be claimed in the year prior to the death of the Settlor. Additionally, the trust is not entitled to the enhanced tax credit offsetting up to 100% of income that is available where the gift is by will, so the trust will be limited to a credit offsetting only 75% of income.

CONCLUSION

It will be apparent from the foregoing that, although there are a number of potential benefits to be gained through the use of an alter ego or joint partner trust, as with any other trust arrangements there are many potential complexities and technicalities which must be addressed to ensure that unanticipated adverse consequences do not result.

Inter vivos trusts have many potential uses, such as providing for minor, disabled and spendthrift beneficiaries, providing for the distribution of property apart from the Settlor's estate, and the establishment of a charitable remainder trust, most of which can be accomplished notwithstanding that the trust is structured as an alter ego or joint partner trust. Accordingly, Canadian residents who are 65 years of age or older and are considering establishing an *inter vivos* trust for any number of reasons should consider whether doing so as an alter ego or joint partner trust and thereby gaining the benefit of an entitlement to roll property into the trust on a tax deferred basis would be advantageous in the circumstances.

The avoidance of estate administration tax is not the only purpose for establishing a trust as an alter ego or joint partner trust, and there are other means of minimizing or avoiding estate administration tax which may be more appropriate and more cost-effective in the particular circumstances and which should be considered for that purpose before the course of

action of establishing an alter ego or joint partner trust is adopted.

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