

ALTER EGO TRUSTS

A. Introduction

Alter ego trusts, joint spousal trusts and joint common-law partner trusts are relatively new types of trusts allowed under the *Income Tax Act* (Canada) that permit the transfer of assets into a trust without triggering a disposition at the point of insertion. The disposition is deferred until the date of death of the settlor in an alter ego trust and until the date of death of the survivor of spouses or common-law partners in a joint spousal or joint common-law partner trust.

Contributors of alter ego, joint spousal and joint common-law partner trusts must be sixty-five years of age and must be solely entitled to receive the benefit of the income of the trust during their lives.

These types of trust are useful for a number of reasons, including: probate avoidance, confidentiality, avoiding claims under dependants' relief legislation, and jurisdiction shopping for lower tax rates.

These types of trust are taxed as *inter vivos* trusts, meaning they are taxed at the highest applicable combined federal/provincial income tax rates. In addition, any subsequent trusts created using the capital from an alter ego, joint spousal or joint common-law partner trust are taxed as *inter vivos* trusts.

B. Structure

Alter ego trusts are created by an individual settlor who is also the sole income beneficiary of the trust. Joint spousal trusts or joint common-law partner trusts are created by one or both spouses or common-law partners as settlor(s) who are also the sole income beneficiaries of the trust. The structural requirements for these trusts, being creations of the *Income Tax Act* (Canada), are determined by that *Act*. The structural requirements of an alter ego trust are as follows:

- *Settlor Age Sixty-Five* - An alter ego trust is formed when a settlor who is sixty-five years of age or older places assets in trust for his or her benefit.
- *Settlor Entitled to All Income* - The settlor must be entitled to receive all of the income generated by the trust in each taxation year during his or her life but does not have to be entitled to the capital of the trust and can choose limited or expanded access to capital including having the capital fully accessible, accessible only in emergencies or completely inaccessible.
- *No Other Income or Capital Beneficiaries Allowed* - No one other than the settlor can be entitled to receive any of the income or the capital while the settlor is alive.

- *Capital Passed on After Death* - After the settlor's death the trust can designate beneficiaries to receive the property outright or in a continued trust(s).
- *Inter Vivos Trusts Only* – An alter ego trust cannot be set up by testamentary instrument, although it may be revocable.
- *Must be created after December 31, 1999* - No trust created before January 1, 2000 qualifies.

The structural requirements of a joint spousal or joint common-law partner trust are as follows:

- *Established for a Couple* - A joint spousal or joint common-law partner trust is set up for the benefit of a couple. They have to be spouses or common-law partners within the meaning of the *Income Tax Act* (Canada). Common-law partners are person, same sex or opposite sex, who have resided together in a conjugal relationship for a period of one year or more.
- *One or Both Can Act as Settlor if Age Sixty-Five* - One or both spouses or common-law partners may be settlors and contribute property to the trust, provided that the contributor is at least sixty-five years of age.

- *Couple Entitled to All Income* - The spouses or common-law partners have to be entitled to receive all of the income generated by the trust throughout their lives but do not have to be entitled to the capital of the trust and can choose limited or expanded access to capital including having the capital fully accessible, accessible only in emergencies or completely inaccessible.
- *No Other Income or Capital Beneficiaries* - No person other than the spouses or common-law partners can be entitled to receive any income or capital from the trust while either one of them is still living.
- *Capital Passed on After Second Death* - After both spouses or common-law partners have died the trust can pass the property to other beneficiaries.
- *Inter Vivos Trusts Only* – These trusts cannot be set up by testamentary instrument, although they may be revocable.
- *Must be created after December 31, 1999* - No trust created before January 1, 2000 qualifies.

C. Tax Treatment

If an alter ego, joint spousal or joint common-law partner trust has been successfully established, it has tax implications at the moment it is created; has tax implications for the beneficiaries while they are alive; and has tax implications at the time of their death, as follows:

- *No Disposition at Insertion* - If an alter ego, joint spousal or joint common-law partner trust is established, no taxes are payable by the settlors as a result of, and at the time of, the transfer of property into the trust. The trust is deemed to have acquired the assets at the original cost base of the settlor(s). Settlers of alter ego trusts are able to elect to opt out of this tax treatment, thereby allowing the trust to receive normal tax treatment as an *inter vivos* trust, including triggering capital gains and losses at the point of creation and the deemed disposition and reacquisition of property for tax purposes every twenty-one years.
- *No Deemed Disposition at Twenty-One Years* - Alter ego, joint spousal and joint common-law partner trusts are exceptions to the general tax rule that deems a disposition and reacquisition of trust property every twenty-one years.

- *Income Attribution to the Settlor* - The settlor(s) normally retain some right to access capital in the form of capital distributions from the trust, or to revoke the trust and take the whole of the capital back into their own hands. This will generally result in income attribution back to the settlor. By structuring the trust to deny any access to capital it is possible to avoid that income attribution and, thereby, have the trust income taxed in the hands of the trust. Since all of the income earned in an alter ego, joint spousal or joint common-law partner trust is taxed at the highest applicable combined federal/provincial income tax rates the attribution of income may be preferred since individual beneficiaries are entitled to graduated tax rates. Attribution of income in an alter ego trust is simple: it is taxed on the settlor's tax return. It is less simple in a joint spousal or joint common-law partner trust. If all of the capital were settled into the trust by only one of the spouses or common-law partners, then it is taxed on that settlor's return. Where both spouses or common-law partners have contributed assets to the trust the income is normally attributed to both of the settlors in the same proportions as their original contribution of capital property.
- *Retaining Income in the Trust* - One restriction to qualifying as an alter ego, joint spousal or joint common-law partner trust relates to entitlement(s) to income. For an alter ego trust the settlor must solely be entitled to receive all of the income earned in any taxation year.

In the case of a joint spousal or joint common-law partner trust both spouses/common-law partners must be solely entitled to receive all of the income earned in any taxation year. While the settlor, individual, spouses or common-law partners, as the case may be, have to be entitled to receive all of the income generated in a given year, it need not be paid out to any of them during the year. The income beneficiary(ies) may have the discretion to leave income in the trust and allow it to accumulate without actually receiving the income in their own hands, and still meet the requirement for “entitlement”. The discretion to not be paid the income must be that of the beneficiary(ies).

- *Disposition at Death* - When the settlor of an alter ego trust or the last beneficiary of a joint spousal or joint common-law partner trust passes away, all of the property in the trust will be deemed to have been disposed of at its fair market value at the date of such death. This triggers pent-up capital gains or losses and brings them into the income of the trust at the trust’s applicable federal-provincial marginal tax rate. The income is reportable on the trust tax return not the terminal return of the deceased settlor.

D. Planning Opportunities

There are estate planning opportunities inherent in the use of alter ego trusts, joint spousal trusts or joint common-law partner trusts:

- *Probate Avoidance* - The trust will generally contain terms that provide for an ultimate distribution of capital after the primary beneficiaries have passed away. The capital can be divided up and paid directly to beneficiaries or can be held in continuing trust. Since the trust assets will pass outside of the estate they do not attract probate fees. Probate avoidance would not be achieved if the terms of trust expressly added the trust property back into the estate of the deceased.
- *Confidentiality* – Generally, all assets of a person's estate must be fully disclosed with an application for a grant of probate. This makes the nature and extent of a person's estate assets a matter of public record, which may be undesirable for those wishing to maintain privacy concerning their financial affairs. Since the assets in alter ego trusts, joint spousal trusts and joint common-law partner trusts are not the assets of the deceased settlor(s) it is not necessary to disclose their existence with an application for grant of probate.
- *Control of Capital* - Once assets have been placed into an alter ego trust, joint spousal trust or joint common-law partner trust, restrictions can be made to control the use of capital while the settlors are alive and to determine the destination of the capital after death. The extent of access and destination of capital after death are determined by the terms of the trust formulated at the time the trust is created.

- *Creditor Proofing* – As long as the settlors do not have continuing access to the capital, a trust can provide a measure of protection from creditors of the settlor(s). This won't allow settlor(s) to dump property into a trust for the purpose of avoiding existing creditors, which transaction may be turned aside as a fraudulent conveyance. Most provinces and territories have laws that allow such a transfer of assets to be challenged where the transfer is tantamount to a fraudulent conveyance or preference.

- *Protection Against Possible Second Marriages* - If a spouse or common-law partner passes away and the survivor remarries or enters a common-law relationship, the new spouse or common-law partner may acquire claims against the assets of the initial couple. The claims of the new spouse or common-law partner are statutory and can interfere with the original intentions of the initial couple. However, if the initial couple placed some or all of the property in a joint spousal trust or joint common-law partner trust and the survivor does not have the power to access capital, then the rights of the new spouse or common-law partner to the assets in the trust may be limited or non-existent. Different provinces and territories have different laws. Most will have some methods available to allow the new spouse or common-law partner to attempt to access the trust for capital. Depending on how and when the trust was arranged, however, that may be a difficult, or impossible, claim to pursue.

- *Incapacity Planning* – An individual may wish to ensure that his or her assets are administered appropriately and seamlessly during any period of time that he or she becomes incapacitated. One way to achieve this is through the use of a Power of Attorney. Another way is through the use of an alter ego trust, joint spousal trust or joint common-law partner trust. The alter ego, joint spousal or joint common-law partner trust may prove to be a more seamless vehicle since the trustee, including a trust company, can be in charge and control of the assets before the incapacity occurs. As a downside, individuals will also typically own property outside of the trust, which property will not be subject to the control of the trustees. In that event, it will still be necessary to have a power of attorney in place to administer that property during an incapacity.

- *Jurisdiction Shopping* – In most circumstances, all of the income in an alter ego trust, joint spousal trust and joint common-law partner trust will be attributed back, to the settlor(s), whether they actually receive the income or not. This is because the settlors will generally choose to retain some control of the capital, which, as earlier discussed, will make the attribution rules apply. The only way to prevent the application of the attribution rules is to prevent the settlor(s) from having any access to the capital transferred to the trust. If the settlor(s) are willing to relinquish control of the capital, the strategy can provide an opportunity for jurisdiction shopping.

For this strategy to work, it requires a structure that does not attract income attribution to the settlor. Where tax residency is successfully established in another province, and attribution rules do not apply, the income will be taxed in that province if retained in the trust, or if paid or payable to the beneficiary, provided that an appropriate designation is made under subsections 104(13.1) and (13.2) of the Act.

For example, assume that an individual resides in Manitoba, where the combined federal/provincial tax rates are among the highest in Canada. The individual can set up and settle property into an alter ego trust and appoint a person residing in Alberta to be the trustee. The applicable tax rates to the income of the trust are those of the province in which the trustee is resident, here Alberta. If the terms of trust provide for the settlor to relinquish control of the capital the income of the trust will not be attributed back to the settlor. The income will be taxed in the trust on its trust tax return. An alter ego trust resident in Alberta will pay taxes at the combined federal/provincial rates applicable to Alberta. Those rates are significantly lower than most of the provinces in Canada, including Manitoba.

In addition, the income from the trust can be paid out to the settlor in the year it is earned, but still be taxed in the trust by virtue of the provisions of the *Income Tax Act* (Canada) that allow for designated income.

The income is thereby taxed on the trust return, at the low Alberta rates, notwithstanding that it is paid to and enjoyed by a beneficiary living in Manitoba, which has higher rates of combined federal/provincial income tax.

E. Disadvantages

There are disadvantages to the use of alter ego, joint spousal or joint common-law partner trusts.

- *Loss of Marginal Rates at Death* – When the settlor of an alter ego trust dies the trust is deemed to have disposed of its capital property at its fair market value and to have reacquired it at the same value. This will trigger any pent up capital gains and losses which will be taxed in the hands of the trustees as income of the trust, not as income of the deceased settlor. All of the income will be taxed at the highest applicable combined federal/provincial tax rate. The same is true of a joint spousal or joint common-law partner trust after the death of the survivor of the spouses/ common-law partners.

Absent an alter ego, joint spousal or joint common-law partner trust the assets are those of the deceased and any capital gains and losses will be taxed on his or her personal terminal tax return, entitling him or her to the benefit of the graduated tax system.

This allows more than \$90,000.00 in income to be taxed at the lower rates of the first three tax brackets. Access to lower marginal tax rates can save income taxes where the deceased has little other income, either because they pass away early in the tax year or they have no significant source of other income during the year of death.

- *Cannot Convert into Testamentary Trust* - If an individual desires to create testamentary trusts for beneficiaries, an alter ego trust, joint spousal trust or joint common-law partner trust can interfere with that plan. Once the property is settled into an alter ego trust, joint spousal trust or joint common-law partner trust it becomes difficult or impossible to later transfer the property to a testamentary trust. Canada Revenue Agency takes the position that any successor trust will not qualify as a testamentary trust.

For example, an alter ego trust might provide that on the death of the settlor, Sam, the proceeds of the trust would be transferred to new trustees to hold in a subsequent trust for the benefit of his niece, Nadine. According to Canada Revenue Agency, Nadine's trust will not qualify as a testamentary trust.

It will, accordingly be taxed as an *inter vivos* trust, thereby attracting the highest applicable combined federal/provincial marginal tax rate without access to the graduated tax rates otherwise available to testamentary trusts.

F. Additional Technical Content

The following is additional technical content relevant to alter ego, joint spousal and joint common-law partner trusts:

- *Gifts to Charity Out of Trust* - When an alter ego, joint spousal or joint common-law partner trust is established, and the capital in the trust, under the terms of the trust, is ultimately to be paid to a named charity, an issue arises as to the use of the tax receipt. If the trust were to qualify as a charitable remainder trust, then the tax receipt would become available at the time when the assets were inserted into the trust. To qualify as a charitable remainder trust, the settlor can not be allowed access to capital of the trust and the trust cannot be revocable.

Since it is more common with alter ego, joint spousal and joint common-law partner trusts for settlors to maintain the continuing right to encroach on capital, such trusts will not qualify as a charitable remainder trusts.

If the trust document under such circumstances provides that all of the capital is to go to a specific charity, Canada Revenue Agency takes the position that the trust will not be entitled to use the tax receipt in the year the donation is made to offset the trust income. Canada Revenue Agency treats the payment out of the trust as an ultimate capital distribution under the terms of the trust, rather than as a donation.

One way around this may be to leave the trustees with the discretion to ultimately select the charity entitled to receive the funds. This removes the decision of picking the charity from the settlor. This may or may not make the distribution a donation rather than a capital distribution.

Another alternative, although not subject to any ruling from Canada Revenue Agency, would be to claim the charitable receipt and use it against the income in the year of the settlor's death on the settlor's personal income tax return. So long as the settlor retained the discretion to encroach on capital or wind up the trust up to and including the date immediately prior to their death, the argument would be that the settlor on the date of death had, effectively, made the charitable gift at death or the moment before they died. To obtain full credit in the hands of the settlor in the year of death, however, the *Act* appears to require that the gift be made by "will".

It might be possible to reserve a power of appointment in the hands of the settlor, to be exercised in the body of their will that will ultimately designate a specific charity to receive the money. Then, the gift would, at least arguably, be one made "by will". It is hoped that this area will become clearer in time. For now, gifts to charity made out of alter ego, joint spousal or joint common-law partner trusts remain problematic and somewhat uncertain.

- *Compartmentalizing Capital Gains and Losses* –There will be occasions where persons divide their property, placing some in an alter ego, joint spousal or joint common-law partner trust and retaining some in their own name(s). In such a situation the trust assets and the assets retained in the name(s) of the settlors may incur capital gains and capital losses. Normally capital losses can be used to offset capital gains. It is conceivable that trust assets will incur capital gains in the year of death, and that the individual(s) will incur capital losses related to assets owned by them. In that scenario, it may not be possible to offset the losses incurred on the personal assets against the gains incurred on the trust assets, or vice versa. Care should be taken at the time when the alter ego trust, joint spousal trust or joint common-law partner trust is established to ensure that such compartmentalisation will not create a problem.

- *Opting Out of Treatment as an Alter Ego Trust* - There may be circumstances in which an individual wants to establish a trust over his or her assets in an attempt to avoid probate fees, but wants to avoid income tax treatment applicable to an alter ego trust. In other words, the person is not opposed to triggering capital gains and losses when he or she inserts assets into the trust and is content to have trust assets subject to the deemed disposition and reacquisition rules. In those circumstances the person can file an election opting out of that tax treatment in the year in which the trust is established. This option is not available to joint spousal or joint common-law partner trusts.

- *Principal Residence Exemption* - Personal trusts can own a residence and still qualify for the use of the principal residence exemption so long as the beneficiary ordinarily inhabits the residence and otherwise qualifies. This is true for alter ego, joint spousal and joint common-law partner trusts.

When a principal residence is transferred to a qualifying spousal or common-law partner trust, the trust is deemed to have owned the property for those years it was owned by the settlor, and to have occupied it for each year in which it was the settlor's principal residence. This provision ensures that the spousal or common-law partner trust will be entitled on disposition to a "flow-through" of the principal residence exemption to which the settlor would have been entitled.

To the extent that the surviving spouse or common-law partner ordinarily inhabits the property as their principal residence subsequent to the settlor's death, the full exemption on the principal residence will be available to the trust.

- Avoiding Dependant's Relief Legislation - Dependents' relief legislation in various provinces and territories across Canada allow a person to bring a claim against an estate if they were dependent on the deceased prior to death. Depending upon the jurisdiction, the claim is limited to a claim against the estate of the deceased, and cannot attach against any non-estate assets. Thus, in some jurisdictions a dependants' relief claim cannot attach assets in an alter ego, joint spousal or joint common-law partner trust. The remarks made above in the section entitled "Creditor-Proofing" relating to fraudulent conveyances are applicable.

F. Information in this Paper not Substitute for Legal Advice

This paper is intended as an introduction to this topic. It is not a substitute for specific legal advice tailored to a client's particular needs. Any person wishing advice on how to order their affairs, or those of a client, should contact a member of our Wealth and Succession Practice Group. This paper is also based on the laws of Manitoba, and while laws are similar from Province to Province, the content of this paper may not be accurate in other provinces.

G. Conclusion

The use of alter ego, joint spousal and joint partner trusts may or may not be useful estate planning strategies depending on the particular circumstances of the individuals. Care need be taken in establishing these types of trust which have the potential for significant disadvantages if created for the wrong reasons.

This paper only touches on some of the issues that must be given consideration. Each person's particular situation will guide the strategy that is best suited to achieving the goals of the individual.

There is no substitute for sound legal, financial and tax advice in creating and implementing the most advantageous and desirable estate plan.

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