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[¶2540] Alter Ego & Joint Partner Trusts

Traditionally, Canadians have used a will to distribute assets owned at death. However, a number of problems can arise when assets pass under a will. One high-profile issue is probate taxes (basically 1.5% of the gross estate in Ontario and 1.4% of the gross estate in British Columbia). Other problems include the following:

- Under provincial legislation, various classes of dependants can ask the court to rewrite the will if the dependant is not satisfied with the provisions of the will. These statutes may allow a surviving spouse and surviving children to challenge the will based on the criteria outlined by the Supreme Court of Canada in the *Tataryn* decision (]1994[2 S.C.R. 807) . In essence, the court is asked to judge whether the deceased fulfilled his or her moral obligation to the person in question (independent of need). Many clients are concerned about this type of litigation tearing the family apart after their death.
- Probating a will is a public process. The applicable legislation requires that the probate application list all the assets of the deceased and the total value of those assets. This list is available to any member of the public who cares to pay the nominal fee required in order to obtain a copy of the documents.

To avoid these problems, many planners have been using will substitutes in order to transfer assets.

It has always been possible to use an *inter vivos* trust as a will substitute. However, a gift of assets to a non-spousal trust that names other persons as beneficiaries usually results in a disposition of those assets at fair market value for income tax purposes. This can result in the payment of significant income tax at the time of the transfer. However, recent tax changes introduced the concepts of an alter ego trust and a joint spousal trust (now referred to as "joint partner trusts" to take into account the inclusion of same-sex couples). Both concepts apply to trusts established after 1999. A key change is to allow a rollover of assets into a qualifying trust, pursuant to subsection 73(1.01) of the Act. It should be noted, however, that apart from specific changes pertaining to alter ego and joint spouse trust, the normal rules of the Act apply to these trusts. Practitioners are still in the process of analyzing how these rules apply to particular scenarios. Some of the issues that have been identified are discussed below; however, the list is by no means exhaustive. Some practitioners are coming to the view that these trusts may not be as useful as originally thought, especially if other methods of planning are available (e.g., multiple wills).

Each new trust is a modified form of the existing spouse trust. The existing spouse trust rules allow an individual to transfer assets to a trust on a tax-deferred basis provided that the spouse, prior to his or her death,

(a) is entitled to receive all the income of the trust; and

(b) is the only person able to receive the income or capital of the trust.

Alter ego trusts refer to trusts created by those who are least 65 years of age, for their own benefit. A joint partner trust refers to trusts established for the joint benefit of a taxpayer and his or her spouse. Under the provisions, which apply starting in 2000, it is

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possible to transfer assets to these trusts without a current tax liability. These trusts could replace a will since, like a will, they can specify who gets what after a taxpayer passes away.

For both types of trusts, the taxpayer (or the taxpayer in combination with his or her spouse, in the case of a joint partner trust) must be entitled to receive all the income of the trust prior to death. Also, no person may obtain the use of any income or capital of the trust before the taxpayer's death (or that of the taxpayer and the surviving spouse, in the case of a joint partner trust).

An alter ego trust is a trust created after 1999 by an individual who was at least 65 years of age when the trust was created, under which the individual is entitled to all of the income of the trust that arises before the individual's death and no other person may receive or obtain any of the income or capital of the trust before the individual's death.

Because a living trust rather than a will is involved, alter ego and joint partner trusts can be used to avoid probate fees. In fact, they avoid the probate process itself, which involves public disclosure of a deceased's assets and — sometimes more to the point — who gets them. In many cases, an individual will want to leave assets to a certain person but because a probated will is on the public record the disclosure could result in embarrassment to the family. The new trusts avoid this nasty problem.

Like a spouse trust, the alter ego trust and the joint partner trust contemplate that the trust will have contingent beneficiaries who will be able to receive income and capital of the trust after the death of the individual or the surviving spouse (as the case may be). The assets in the trust would then effectively bypass probate, provided that the trust qualified as a true inter vivos trust.

(If the concern is to avoid wills variation legislation, one may have to be careful about the types of powers retained by the individual. In some provinces, an inter vivos trust can become subject to wills variation legislation as a result of powers held by the deceased just before death.

The alter-ego trust and the joint partner trust can also offer additional flexibility to the standard estate freeze. In a typical estate freeze, the principal of the corporation exchanges his or her common shares for retractable shares with a fixed value equal to the value of the corporation. A family trust then subscribes for new common shares at a nominal value, since all the value of the corporation resides in the retractable shares owned by the principal. The principal's retractable shares typically have a significant value and a significant inherent capital gain. In order to avoid triggering the inherent capital gain, the principal usually retains personal ownership of the retractable shares, which exposes those shares to probate. Under the legislation, it is possible for the principal to gift the retractable shares to a joint partner trust without triggering immediate tax on the capital gain. All trust income would be available for use by the principal and the principal's spouse during their respective lifetimes. During the lifetime of the principal, that income would generally be taxed in the hands of the principal under the normal income attribution rules. On the death of the survivor of the principal and the spouse, the assets in the trust would be held for new beneficiaries named in the trust deed (presumably, the children), effectively bypassing probate.

However, the use of alter ego and joint partner trusts can also have some drawbacks.

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- An alter ego or joint partner trust will not circumvent the deemed disposition on death rules: an alter ego trust is deemed to dispose of its assets on the death of the individual who established it; likewise, a joint partner trust is deemed to dispose of its assets on the death of the last surviving spouse.
- As discussed at ¶318, amending a trust may become problematic if the variation is such as to have the effect of resettling the trust. Some practitioners are concerned that this could be problematic even if the trust itself provides an amending formula. If this is indeed an issue, then this would interfere with the flexibility of alter ego and joint partner trusts, since an individual would usually desire the freedom to amend the trust — just like a will. An alternative would be to distribute the assets out of the trust and set up a new trust; however, this could be cumbersome (for example, title would have to be reregistered).
- Trust transfers by a taxpayer who is 65 years of age or older should be monitored to avoid unintended tax consequences. If the trust meets the alter ego conditions, the taxpayer is automatically subject to a rollover and the trust is subject to a deemed disposition on that individual's death. If this result is not desired, the trust must elect under subparagraph 104(4)(a)(ii.1) for its first tax year, not to have the rollover apply. This is a positive step that must be taken to avoid the alter ego rules. The election also must be filed if the taxpayer wants to create a self-benefit trust. Put differently, once the taxpayer is age 65, and notwithstanding that he or she would qualify under one of the other rollovers to a self-benefit trust, the definition of alter ego trust will apply to deem a disposition of the trust assets on death if an election is not made under clause 104(4)(a)(ii.1).
- Spouse and other testamentary trusts have access to the capital gains exemption by virtue of subsection 110.6(12) but alter ego trusts and joint partner trusts do not.
- It is quite likely that assets would be required to be re-registered to reflect the alter ego or joint partner trust as the owner. However, query whether there is a continuing requirement for such registration. This may also pose a problem if, for example, an individual simply opens a new bank account and then purports to transfer the bank account to the trust. This would seem to necessarily require the re-registration of the bank account in the name of trust; otherwise, the bank may well insist on a probated will in respect of the bank account.
- If a taxpayer wants to be a capital beneficiary of the trust, any potential inter-provincial tax planning opportunity is likely unavailable (i.e., shifting assets to a taxpayer (i.e., a trust) in a lower tax rate province such that income and gains will be taxed in that taxpayer's hands). The reason for the foregoing is that, for the most part, the taxation of alter ego and joint partner trusts is governed by the normal tax rules pertaining to trusts. In the above case, the property would normally be held by the trust on condition that it may revert to the transferor; thus subsection 75(2) would apply. However,

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even though subsection 75(2) applies to an alter ego trust, a T3 return must be filed (see also page 1 of the T3), including schedule 9 (allocations) and T3 slips. This requirement was stated by the CCRA in a Technical Interpretation released July 11, 2002, Document No. 2001-0114045, which stated that: “In order to ensure that the income is excluded from the computation of the trust's income, a T3 information slip should be prepared for the settlor and a statement showing the amount of income attributed to the settlor under subsection 75(2) should be submitted with schedule 9 of the T3 tax return as required when the response to question 3 of Part A is in the affirmative.”

- Moreover, once the assets have been transferred to the trust, ownership will no longer be the taxpayer's but the trust's.

An additional drawback to alter ego and joint partner trusts is that, unlike an estate, it does not appear that these trusts will be eligible for graduated tax rates after death: it appears that both types of trusts would have to pay tax at high rates, unless the income is distributed to beneficiaries. This precludes the possibility of a will planning manoeuvre known as estate splitting — i.e., using low tax rates available to an estate to reduce taxes. What is interesting about these trusts reduce is that they reduce provincial probate fees while increasing federal income tax.

The Family Law Act

The transfer of property to a joint partner trust may have the effect of eliminating a spouse's equalization rights under the Family Law Act (Ontario), without the undesired tax consequences. Suppose that an individual, Bill, were to remarry. Bill transfers his investment portfolio to a joint partner trust under which he and his new spouse have life interests and Bill's children are entitled to the capital after the later to die of Bill and his spouse. The trustees may also have the power to encroach on capital in favour of Bill and his spouse. Suppose further that Bill predeceases his spouse and, under his will, he leaves his spouse with a life interest in his estate. At the valuation date (i.e., the date before the date of Bill's death), Bill would no longer own the investment portfolio; all he would have is an income interest in the joint partner trust. His spouse would have an identical income interest in the same trust. Arguably, these equal interests should effectively neutralize each other in the context of determining the equalization payment to which his spouse would be entitled. In effect, the joint partner trust should not only eliminate any need to pay Ontario probate taxes at the time of Bill's death, it may also arguably eliminate his spouse's right to an equalization payment vis-à-vis the investment portfolio.

Careful consideration must be given to the terms of the trust in order to avoid any argument that the trust was established in bad faith.(1) For example, arm's length trustees should be appointed, both spouses should be given an equal income interest, and the power of encroachment in favour of both spouses should be the same. If the income interests are fully discretionary, with the only proviso being that all income must be distributed annually to the income beneficiaries, a court may not necessarily value the interests of an individual and his or her spouse equally. There may be, however, certain inherent problems relating to the appointment of trustees for these types of trusts. Usually, the settlor (i.e., the taxpayer who would be transferring the property to a joint partner trust or alter ego trust) would want to be a trustee of the trust, with the power to distribute

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whenever he or she wanted. However, if the matter went to court in order to defeat any equalization claim brought by the spouse, the taxpayer would most likely not garner any sympathy from the court due to the fact that the taxpayer has effectively held the purse strings at all times by controlling the distributions from the trust. Alternatively, if a third party was appointed as a trustee, the settlor may have a difficult time asking for the property to be returned to him or her as the trustee would have a fiduciary duty to the residual beneficiaries.

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Endnotes

1 (Popup - Popup)

Stone v. Stone, 55 O.R. (3d) 491, Ont. C.A., may also be relevant.

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