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ALTER EGO TRUSTS AND JOINT PARTNER TRUSTS

This issue of the Legal Business Report provides current information to the clients of Alpert Law Firm on estate planning, including alter ego and joint partner trusts. Alpert Law Firm is experienced in providing legal services to its clients relating to estate planning, including the preparation of wills, deeds of gift, trust documents and all documentation necessary in connection with estate freezes and other tax, corporate and estate planning matters.

A. ESTATE ADMINISTRATION TAX IN ONTARIO

When a will is probated in Ontario, pursuant to the *Estate Administration Tax Act,* a tax or "probate fee" is levied on the value of any assets that are subject to the will. These "probate fees" are imposed in addition to any income tax arising pursuant to the *Income Tax Act* (the "Act") and any other applicable taxes. Any assets that flow through a probated will are taxed at $5 per $1,000 on the first $50,000 worth of assets and $15 per $1,000 thereafter. As an example, a probated estate worth $10 million would be liable to remit approximately $150,000 of Estate Administration Tax.

B. ALTER EGO TRUSTS AND JOINT PARTNER TRUSTS

Under section 73 of the *Income Tax Act* (the "Act"), a person who is at least 65 years of age can use an alter ego trust and/or a joint partner trust as an alternative to a will to transfer assets free from the estate administration tax, or "probate fees", levied under the provisions of the Ontario *Estate Administration Tax Act*. Assets held in an alter ego trust and a joint partner trust are distributed outside of the estate and on the death of the settlor based on the terms of the trust.

An alter ego trust is a trust where (i) the settlor is also the beneficiary of the trust during his or her lifetime; (ii) the settlor is over 65 years of age; (iii) the settlor and the trust are resident in Canada; (iv) the settlor is entitled to receive all of the income of the trust that arises prior to his or her death; (v) no person other than the settlor can receive or otherwise obtain the use of the income or capital of the trust while the settlor is alive; and (vi) the trust has not elected to not be considered an alter ego trust in the return for its first taxation year.

A joint partner trust is a trust where (i) the settlor and the settlor's spouse or common-law partner are the beneficiaries until the death of the surviving partner; (ii) the settlor is over 65 years of age; (iii) the settlor and the trust are resident in Canada; (iv)

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the settlor and/or the settlor's spouse or common-law partner are the only people entitled to receive or obtain the use of all of the income that arises the death of the surviving partner; and (v) no person other than the settlor and/or the settlor's spouse or common-law partner can receive or obtain the use of the income or capital of the trust until the death of the surviving partner.

The income of an alter-ego trust is taxed at the hands of the settlor at graduated rates unless he or she makes an election for the income to be taxed in the trust. Income of a joint partner trust is taxed in the hands of the settlor and his or her spouse or common-law partner at graduated rates unless they make an election for the income to be taxed in the trust. Income taxed in the trust is taxed at the highest marginal tax rate for individuals.

When a trust is established, it is important to re-register assets to indicate that the trust, not the individual, is the new owner. This is necessary to ensure that a third party, such as a financial institution, will not insist on probate before releasing assets. However, if land is transferred to a trust, care should be taken to ensure that the trust does not receive a beneficial interest in the land in order to avoid triggering land transfer tax.

In addition, as with any trust, upon establishing a joint partner or alter ego trust, careful attention should be given to keeping accurate records and filing annual tax returns on behalf of the trust.

C. BENEFITS OF ALTER EGO TRUSTS AND JOINT PARTNER TRUSTS

On the death of a settlor, assets in an alter ego trust and joint partner trust can be transferred without having to go through the probate process. Since the assets are transferred to the trustees during the settlor's lifetime, this can reduce the time and expense of transferring assets to beneficiaries upon the death of the settlor. In addition, since the assets are already held by the trustees, there is a continuity of management of the assets.

Where assets are transferred by way of a gift to a trust that names individuals other than the donor as beneficiaries, this will generally result in a deemed disposition of those assets at fair market value ("FMV") under the Act, thereby triggering income tax at that time. However, a gift of assets to an alter ego trust or a joint partner trust will allow the transferor to transfer assets to the trust on a tax-deferred, rollover basis. The property is deemed to be transferred to the trust at its cost amount pursuant to the

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provisions of subsection 73(1) of the Act, unless the settlor makes a special election to opt-out of this rollover provision and have the disposition take place at FMV.

The alter ego trust and the joint partner trust may also have contingent beneficiaries who will be able to receive income and capital of the trust after the death of the settlor or the surviving partner as the case may be.

As stated previously, a common use of alter ego trusts and joint partner trusts is to reduce or eliminate estate administration tax. Another benefit of avoiding probate through the use of an alter ego trust is confidentiality. When a will is probated it becomes a public document. However, there are no public disclosure requirements or reporting requirements for an alter ego trust, other than to the Canada Revenue Agency (the "CRA").

D. <u>TRUST RESIDENCY</u>

Following the Supreme Court of Canada's decision in *Fundy Settlement v Canada* (2012 SCC 14), the CRA has clarified in its Income Tax Folio that a trust's factual residence will be determined to be where its central management and control ("CMC") actually take place. In *Fundy Settlement*, the Supreme Court remarked that the test for residence of a corporation has long been the location of its CMC and there would have to be good reasons for the test for residence of a trust to be different from that of a corporation. The Supreme Court held that no such reasons were given and adopting the CMC test for trusts would promote consistency, predictability, and fairness in the application of tax law. Consequently, the residence of a trust is not necessarily the same as the residence of the trustee(s).

In the CRA's Income Tax Folio S6-F1-C1 ("S6-F1-C1"), the CRA says that it will take any relevant factor into consideration when determining the jurisdiction of a trust's CMC, which may include: (i) the factual role of a trustee and other person with respect to the trust property, including any decision-making limitations imposed thereon, either directly or indirectly, by any beneficiary, settlor, or other relevant person; and (ii) the ability of a trustee and other persons to select and instruct trust advisors with respect to the overall management of the trust. Although *Fundy Settlement* only involved a trust with one trustee, S6-F1-C1 says that when there is more than one trustee involved in exercising the CMC over a trust, the trust will reside in the jurisdiction in which the more substantial CMC actually takes place. A possible result of the CMC test is that trust will be determined to be a resident of Canada even if another country considers the trust to be resident in that other country.

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Even if the CMC of a trust is not in Canada, the trust may be deemed to be a resident of Canada under section 94 of the Act. The residence deeming provisions in section 94 of the Act may apply when a trust that is factually resident in Canada has a contributor that is a Canadian resident and a beneficiary that is a Canadian resident. Under section 94 of the Act a trust is only deemed to be a Canadian resident for specific purposes, including calculating the income of the trust and its liability for tax under Part I of the Act, but not for the purpose of the attribution rules in subsection 75(2) of the Act, which are discussed in greater detail in Part D of this memorandum.

E. CAPITAL GAINS TAX PLANNING CONSIDERATIONS

Joint partner and alter ego trusts are not eligible for the lifetime capital gains exemption on the disposition of shares of a qualified small business corporation. Therefore, an individual creating an alter ego trust or joint partner trust should elect out of the rollout provisions of subsection 73(1) of the Act in order to claim the capital gains exemption at the time of the disposition of these shares to the trust.

Consideration must be given to the type of trust which would yield the most beneficial capital gains tax results. Generally, when assets are transferred to an *inter vivos* trust, there is a deemed disposition of these assets at FMV and any accrued capital gains are taxed in the hands of the settlor. Later, it may be possible to transfer these assets *in specie* from the *inter vivos* trust to the beneficiary on a tax-free basis, prior to the 21st anniversary date of the settlement of the trust. As a result, the beneficiary may be able to defer capital gains tax on any accrued gains on these assets until the beneficiary disposes or is deemed to dispose of these assets.

Assets can be rolled over into alter ego and joint partner trusts at their cost amounts. Additionally, a principal residence can generally be transferred into these types of trusts without losing the eligibility for the principal residence exemption. Since alter ego and joint partner trusts qualify as “personal trusts” under the Act, the principal residence exemption can be claimed in respect of an actual or deemed disposition of a principal residence.

Alter ego and joint partner trusts are not subject to the same 21-year deemed disposition rule that is generally applicable to other types of trusts, including spousal trusts. Alter ego and joint partner trusts are deemed to dispose of their assets at FMV upon the death of the settlor or surviving spouse, respectively. The 21-year deemed disposition rule for alter ego and joint partner trusts commences after the above-mentioned initial deemed disposition, the death of the settlor or surviving partner, as the case may be.

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In some situations, putting assets into an alter ego trust could result in an acceleration of capital gains tax. If a person holds assets directly, upon death these assets can be rolled over tax-free to the person's surviving spouse. However, if these assets are held by an alter ego trust, upon the death of the settlor there is a deemed disposition of assets at FMV and tax will become payable. This problem could be avoided by using a joint partner trust rather than an alter ego trust, although a joint partner trust may be undesirable for other reasons.

Alter ego and joint partner trusts require the trust's income to be paid to the beneficiary. Under subsections 104(13.1) and (13.2) of the Act, it is possible to designate this income to the trust so that it would not be taxed in the hands of the beneficiary. Subsection 104(13.3) of the Act, states that the income otherwise payable, and therefore taxable, to a beneficiary can only be designated to a trust to the extent that the trust will not have any taxable income as a result of the designation. Consequently, income will only be able to be designated to the trust when it has loss carry-forwards that will offset the designated income.

In addition, subsection 104(13.4) of the Act will deem a year-end to be triggered upon the death of the settlor of an alter ego trust or the surviving partner beneficiary of a joint partner trust. For this deemed taxation year, trust income, including any capital gains triggered as a result of the death, will be taxed in the deceased beneficiary's terminal tax return, and not in the trust's tax return. A designation under subsection 104(13.1) of the Act will not be available in this situation, so the beneficiary will not be able to use it to designate the terminal income to the trust.

Additionally, the beneficiary and the trust will be jointly and severally liable for the terminal tax. Consequently, if the beneficiary's estate does not have sufficient assets to pay the tax, the CRA may collect the tax from the trust assets. This new provision raises fairness concerns in situations like the following: a husband has a joint partner trust with his second wife where the capital of the trust is to be left to the husband's children from his first marriage upon the death of the surviving spouse and the second wife's beneficiaries are her children with the husband. Assuming the husband predeceases his second wife, upon the death of his second wife, pursuant to subsection 104(13.4) of the Act, any trust income, including capital gains triggered as a result of her death, will be payable by her estate and the effective result is that the husband's children from his first marriage get a windfall, by not having to pay the tax out of the trust assets upon the death of their father's second wife, to the detriment of the wife's estate, and consequently her children.

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In response to the concerns about fairness that have been raised about this new provision, the Department of Finance has stated that its intention is that the trust will be assessed for the terminal tax as though it were liable in the first instance. However, it is uncertain as to whether the CRA will administer this provision as suggested by the Department of Finance, since its current practice is to assess and initiate collection against the primary taxpayer, the beneficiary, and to only initiate proceedings against other taxpayers, the trust, as a last resort.

Subsection 164(6) of the Act allows a graduated rate estate to carry estate losses realized in the estate's first taxation year back to the deceased's terminal tax return. This carry-back is not available for alter ego or joint partner trusts. Alter ego and joint partner trusts may be able to use the carry-back rules under section 111 of the Act. However, the stop-loss provisions in subsection 40(3.6) of the Act would deny such a capital loss carry-back when the disposed property is shares and the trust is found to be affiliated with the corporation after the death of the shareholder. Therefore, it is important to ensure that alter ego trusts are drafted to avoid the stop-loss rules and to give trustees the necessary flexibility and time to implement the appropriate tax planning.

F. ADDITIONAL TAX PLANNING CONSIDERATIONS

It is the position of the CRA that because alter ego and joint partner trusts are *inter vivos* trusts, they will not be considered testamentary trusts as defined in the Act. This means that they cannot be used for the purposes of estate-splitting, which involves setting up several trusts such that each receives the lowest marginal tax rate possible.

Both the alter ego and joint partner trust can designate a property as a principal residence. As a result, the principal residence exemption will be available to the trust when the property is deemed to be disposed.

It is important to note that since a transfer of property to an *inter vivos* trust constitutes a "supply" under the *Excise Tax Act*, it will be subject to HST unless it is considered to be an exempt supply, such as shares of a corporation or used residential property, including a principal residence or a cottage property. The transfer of a commercial property, certain farm properties, or some types of vacant land to this type of trust will be subject to HST.

If a person plans to make charitable donations upon death, care must be taken to find the most tax efficient way of doing so. Trusts may only claim donation tax credits to a maximum of 75% of their income for the year, whereas deceased individuals may

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claim disability tax credits against 100% of their income. Individuals should ensure that they arrange their affairs to maximize their tax credits.

If a trustee ceases to be resident in Canada, this could result in a change of residence of the trust, thereby causing a deemed disposition of the trust assets at FMV. Other complications, including the potential for double taxation, can arise where the settlor of a trust is a resident of Canada but is a citizen of another country. Taxpayers who may be residents or citizens in foreign jurisdictions should be particularly careful in planning their affairs.

There cannot be a rollover into an alter ego trust of property that is not capital property. The following types of property cannot be rolled over into an alter ego trust but may be rolled over into a corporation pursuant to subsection 85(1) of the Act: eligible capital property, inventory, and Canadian and foreign resource properties. It is therefore possible to first rollover these types of properties into a corporation pursuant to subsection 85(1) of the Act and then rollover the shares of the corporation into the alter ego trust.

Certain common assets cannot be transferred into these types of trusts, most notably RRSPs and RRIFs.

Under subsection 75(2) of the Act, gains or losses that are realized from the disposition of property that is contributed to trust capital may be attributed to the contributor. However, in a policy statement issued on March 25, 2009, the CRA has indicated that where certain conditions are met, a third party such as a family member of the trustee, may provide an interest-free loan to an alter ego trust without attracting the attribution consequences pursuant to subsection 75(2) of the Act. The CRA relied on the decision rendered by the Tax Court of Canada in *Howson v The Queen*, 2006 TCC 644. The Tax Court of Canada confirmed that where an interest-free loan is established independently from a trust, the attribution rules pursuant to subsection 75(2) of the Act would not apply to the contributor.

G. RECENT CHANGES TO THE TAXATION OF TRUSTS

Effective December 14 2017, subsection 54(c) of the Act made important changes regarding the principle residence deduction (“PRD”) rules as they relate to the taxation of trusts. Under the old PRD Rules, any Canadian resident personal trust was able to designate a property as a principal residence in taxation years where the trust’s beneficiaries or the beneficiaries’ spouse, common-law spouse, or child inhabited the property as a principal residence.

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Under subsection 54(c.1)(iii) of the Act, the new PRD Rules restrict the ability to designate a principal residence to (i) alter ego trusts; (ii) joint partner trusts; (iii) certain trusts for the exclusive benefit of the settlor during the settlor's lifetime; (iv) “qualified disability trusts” in which the beneficiaries are the spouse, common law partner, or child of the settlor; and (v) inter vivos trusts in which the beneficiaries are both (a) the minor children of the settlor; and (b) have parents who died in preceding years.

Additionally, the new PRD Rules require that the occupant of the property be an eligible beneficiary of the trust and resident in Canada for the taxation year in which the residence is designated a principal residence. As such, it is no longer enough for the spouse or child of a beneficiary to occupy the property as a principal residence.

A special transitional rule exists under subsection 40(6.1) of the Act for previously eligible trusts to shelter gains accrued on previously designated properties up to the end of 2016.

This issue of the Legal Business Report is designed to provide information of a general nature only and is not intended to provide professional legal advice. The information contained in this Legal Business Report should not be acted upon without further consultation with professional advisers.

Please contact Howard Alpert directly at (416) 923-0809 if you require assistance with tax and estate planning matters, tax dispute resolution, tax litigation, corporate-commercial transactions or estate administration.

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