

Alter Ego and Joint Partner Trusts

The purpose of this article is to provide you with some basic information on Alter Ego and Joint Partner trusts, discuss some of its benefits and drawbacks, and outline some scenarios where the use of these trusts may be more beneficial.

WHAT ARE ALTER EGO AND JOINT PARTNER TRUSTS?

An Alter Ego trust is an inter-vivos trust that was created after 1999 in which the person who transferred the assets into this trust (ie. the settlor) must be entitled to receive all the income of the trust during his or her lifetime. In addition, no one but this person can receive or use the income or capital from the trust during his or her lifetime.

If the settlor wishes to include his or her spouse partner as a beneficiary of the trust, then a Joint Partner trust can be used. For purposes of this article, any references to "spouse" also include a common law partner. Like an Alter Ego trust, a Joint Partner trust is also an inter-vivos trust that was created after 1999. Under this trust, the settlor in combination with the settlor's spouse must be entitled to receive all the income of the trust that arose prior to the death of the survivor of the settlor and his or her spouse. Also, no one except for the settlor and the settlor's spouse can receive or use the income or capital from the trust prior to the death of the survivor of the settlor and his or her spouse.

In order to create an Alter Ego or a Joint Partner trust, the settlor must be at least 65 years of age and a resident of Canada (this is not required for the non-settlor spouse in the case of Joint Partner trusts). In addition, a majority of the trustees who manage the trust must also be Canadian residents at the time the assets are transferred to the trust.

HOW DO ALTER EGO AND JOINT PARTNER TRUSTS DIFFER FROM OTHER TYPES OF INTER-VIVOS TRUSTS?

Alter Ego and Joint Partner trusts differ from other types of inter-vivos trusts in two respects. The first is the potential tax implication that arises when property is transferred to the trust. When property is transferred to an inter-vivos trust, the transferor is deemed to have disposed of the property at its fair market value. This could result in immediate tax consequences to the transferor.

For example, let's say you have a portfolio of investments worth \$100,000. You paid \$75,000 for the investments in this portfolio. If you transfer this portfolio to an inter-vivos trust, then you will be deemed to have disposed of the portfolio for \$100,000. You

will realize a \$25,000 (\$100,000 - \$75,000) capital gain as a result and you may be required to pay tax on one-half of this gain. However if you transferred the portfolio to an Alter Ego trust, your disposition price will be equal to your cost, namely \$75,000, which means that you will have no immediate tax consequences.

This is commonly known as a tax deferred rollover. The Alter Ego or Joint Partner trust in this case will inherit your cost base (ie. \$75,000) for the purpose of determining the trust's tax consequences when the portfolio is subsequently disposed of by the trust. It should be pointed out here that in order to be eligible for the tax deferred rollover, both you and the majority of the trustees of the Alter Ego or Joint Partner trust must be Canadian residents at the time the assets are transferred into the trust.

The ability to transfer assets to a trust on a tax-deferred basis is what makes the Alter Ego and Joint Partner trusts so appealing. However you can elect to transfer assets into either one of these trusts on a fair market value basis if you so choose. You may want to do this if the asset that you intend to transfer is in a loss position and you would like to realize the loss to offset other capital gains realized in the year. It may make sense for you to transfer your principal residence, shares of a small business corporation or farm property at its fair market value into these trusts. However, please note that this election is an all or nothing election in that you cannot choose a disposition value between your cost and the fair market value.

The second difference between Alter Ego and Joint Partner trusts and other types of inter-vivos trusts is in regards to the twenty-one year deemed disposition rule. Generally an inter-vivos trust is deemed to have disposed of all its assets at fair market value every twenty-one years. The purpose behind this rule is to prevent a trust from accruing unrealized capital gains over a long period of time. Alternatively, the twenty-one year deemed disposition rule does not apply to Alter Ego or Joint Partner trusts. Instead, the first deemed disposition date for an Alter Ego trust is the date on which the settlor dies. In the case of a Joint Partner trust, the first deemed disposition date at fair market value is the date of death of the survivor of the settlor and the settlor's spouse, regardless of whether these dates occur before or after the 21st anniversary of the trust.

WHAT KIND OF ASSETS CAN I PUT INTO AN ALTER EGO OR JOINT PARTNER TRUST?

In general, almost any kind of asset that you own can be transferred into an Alter Ego or Joint Partner trust. Investment assets such as stocks, bonds, and mutual funds, personal use assets such as your principal residence, and private company shares can all be transferred into these trusts. You cannot however transfer your RSP or RIF directly into these trusts unless the assets are deregistered from the registered plans first, which is generally not advisable since any amount withdrawn from an RSP or RIF will be taxable in the year that it is withdrawn.

CAN I USE A JOINT PARTNER TRUST TO SPLIT INCOME WITH MY SPOUSE?

A Joint Partner trust can provide limited income splitting opportunities with your spouse. The income that can be allocated and taxed in the hands of your spouse will likely be restricted to the second-generation income earned by the trust. This second generation income is the income or capital gains earned on property acquired with income that was previously taxed either in your hands or at the trust level.

WHAT ARE SOME OF THE POSSIBLE BENEFITS ASSOCIATED WITH AN ALTER EGO OR JOINT PARTNER TRUST?

An Alter Ego or Joint Partner trust may provide the following benefits:

1) REDUCTION OF PROBATE TAX

Probate is the judicial process whereby the courts confirm an executor's authority to deal with the assets of an estate. As part of this process, a probate tax is usually payable. The amount of the probate tax that must be paid is usually based on a percentage of the assets of the estate. Assets that have been previously transferred to an Alter Ego or Joint Partner trust will not form part of the estate assets and therefore are not subject to the probate tax.

2) PROVIDE FOR CONTINUOUS MANAGEMENT OF YOUR PROPERTY

If your executor is required to probate your Will, he/she may be prevented from administering your estate until such time as probate is granted, which may take some time. Furthermore, if you own assets such as real estate in different provinces/countries, your executor may be required to probate your Will more than once. This can be both time consuming and costly. By transferring your property into an Alter Ego trust or Joint Partner trust, you may be able to minimize the disruption to the management of your assets since the trustees of your trust will not need to obtain probate in order to administer the trust assets.

3) PRESERVE PRIVACY AND CONFIDENTIALITY

If your Will is probated, it will become a public document. This means that anyone can go to the court and get a copy of your probated Will disclosing both your testamentary intentions as well as the value of your estate. If it is important to you to keep this information private, you can consider transferring your assets to an Alter Ego or Joint Partner trust. The trust document that governs the administration of the trust in this case is a private document and therefore, will not be subject to public scrutiny.

4) POSSIBLE PROTECTION AGAINST ESTATE LITIGATION

It is generally more difficult for a person to challenge the validity of a trust than it is with a Will. In addition, a number of provinces also have laws that enable dependents to challenge the adequacy of the support provisions made for them in the Will. If you want to ensure that your estate is distributed in accordance with your wishes, you may want to consider carrying out your testamentary wishes through an irrevocable trust. It should be noted that it is always possible that a court could always set aside such a transfer or alternatively, consider the trust assets as estate assets in egregious situations (particularly in a claim involving a spouse or minor child).

5) ALTERNATIVE TO A POWER OF ATTORNEY

A power of attorney will allow the person you appoint as your attorney to assist you in managing your assets. If you were to transfer your assets to an Alter Ego trust, you can also appoint the same person as trustee to manage the trust assets. The use of such trusts in incapacity planning can, in certain instances, be more advantageous than using a power of attorney. For example, if you have assets in multiple jurisdictions, you may need multiple powers of attorney since different jurisdictions may have different legal requirements for a power of attorney. If your assets are managed under a trust, the authority of a trustee to act on behalf of a trust will generally be more readily recognized by foreign banks and institutions.

Another example where the use of a trust may be more beneficial than a power of attorney in managing assets is in the case of diminished capacity. A power of attorney will not preclude you from managing your own assets as long as you are mentally capable to do so. However a person often does not become mentally incapable overnight (or admit it even if they are). It is during the period of declining mental health that a person is prone to make decisions in respect of their assets that they would otherwise not make, or to be influenced by non-traditional creditors such as caregivers and second spouses. You may be able to avoid this situation with an Alter Ego or Joint Partner trust if you appoint someone other than yourself as the trustee as you will no longer be able to deal with your assets once it is transferred to the trust.

6) POSSIBLE CREDITOR PROTECTION

A trust can be used to protect your assets from creditors in appropriate circumstances. This is because when an asset is transferred to a trust, ownership of that asset is transferred to the trustee. Since you no longer own the asset, the asset will not be available to satisfy the claims of any future creditors. However, if you are also the income and/or capital beneficiary of the trust, then your creditors may be able to successfully attack your interest in the trust. Therefore, the level of protection provided by an Alter Ego trust or a Joint Partner trust may be restricted since you or your spouse (in the case of joint-partner trust) must be entitled to receive all of the income of the trust. In order to increase the level of creditor protection associated with these types of trusts, you should not be a capital beneficiary of the trust.

It should be pointed out that if the purpose behind transferring assets to a trust was to avoid or defeat a known creditor (or possibly a spouse), it is likely that in this case the transferred assets will not be out of the reach of the creditors.

7) POSSIBLE REDUCTION OF INCOME TAX

In limited circumstances, the use of an Alter Ego or Joint Partner trust can actually result in a reduction of income tax paid. If the trust is structured properly, then the income earned by the trust can be taxed in a province that has a lower tax rate. However, it should be noted that a number of provinces have general anti-avoidance tax rules that can be used to challenge the transfer of assets to an Alter Ego or Joint Partner trust resident in another province.

8) POSSIBLE REDUCTION OF OAS CLAWBACK

If you are subject to Old Age Security (OAS) clawback, a properly structured Alter Ego or Joint Partner trust may be able to help you reduce the amount of the clawback.

WHAT ARE SOME OF THE DISADVANTAGES ASSOCIATED WITH ALTER EGO OR JOINT PARTNER TRUSTS?

The following are some possible drawbacks associated with Alter Ego or Joint Partner trusts:

1) LOSS OF TESTAMENTARY TRUST PLANNING

A common estate planning objective is to reduce the amount of taxes payable by your beneficiaries on the asset that they inherit. If you have a beneficiary who is at or near the top marginal tax rate, you can consider using a testamentary trust to reduce the overall taxes paid on the income earned on their inheritance. Instead of making a direct bequest to this beneficiary, you could have their inheritance held in a trust. The income earned by the trust can then be taxed at the trust level, which is subject to graduated tax rates. If the beneficiary were to earn this income directly, it is likely that all of the income would be taxed at or near the highest marginal tax rate, resulting in a greater amount of taxes paid.

If you choose to distribute your assets through an Alter Ego or Joint Partner trust, you may forfeit the ability to create testamentary trusts. The Canada Revenue Agency (CRA) has stated that it will consider any successive trust created within an Alter Ego or Joint Partner trust to be an *intervivos* trust and therefore, be subject to tax at the top marginal tax rate.

2) COST AND COMPLEXITY

An Alter Ego or Joint Partner trust can cost several thousand dollars in legal fees to establish. Once it is established you may continue to incur ongoing administration costs such as accounting and/or trustee fees. In addition, you may also want to consider the

time required of your trustees in administering your trust and filing the necessary tax returns.

3) CONTROL AND FLEXIBILITY

You should be aware that you might lose control over those assets that you transferred to an Alter Ego or Joint Partner trust. Once the assets are transferred into the trust, the trustees will assume control of these assets. It is possible for you to retain control of these assets if you appoint yourself as the sole or controlling trustee, but if you do so, you will lose the ability to use the trust to reduce the overall taxes paid as discussed previously (#7: Possible Reduction of Income Tax). A trust is also generally more difficult to amend once it is established compared to a Will, since a Will can simply be amended by using a Codicil.

4) POTENTIALLY A GREATER AMOUNT OF INCOME TAXES PAYABLE AT DEATH

Remember that subject to certain exceptions permitted in our income tax law, you are deemed to have disposed of all your assets immediately before your death. Half of any resulting net capital gains will be included on your terminal tax return and subject to tax at your marginal tax rate. For assets that you have transferred into an Alter Ego or Joint Partner trust, these assets will also be deemed to have been disposed of by the trust at the time of your death (or on the death of the survivor of you and your spouse in the case of a Joint Partner trust). The trust cannot, in this case, allocate the resulting capital gains income to your estate. Instead the trust will have to pay capital gains tax on this amount at the top marginal tax rate. Therefore, if you are currently in a low marginal tax rate and you don't expect this to change in the near future, you may actually end up paying more taxes by transferring assets into an Alter Ego or Joint Partner trust. This problem can be avoided through proper tax planning by either electing to transfer assets at their fair market value to realize the capital gains immediately, or by having the trust realize a portion of its unrealized capital gains each year and then allocate this income to you so that it may be taxed at your lower marginal tax rate.

5) CHARITABLE DONATIONS

If it is your intention to make charitable donations during your lifetime, you may want to set aside some assets to carry out this intention since an Alter Ego or Joint Partner trust will be prohibited from distributing any of its income or capital to anyone other than you or your spouse (in the case of a Joint Partner trust). You can however choose to donate the income that you receive from these trusts to a charity in order to receive a donation tax credit.

It is possible for you to designate a charity as a beneficiary of your Alter Ego or Joint Partner trust to receive the trust property subsequent to your death (Alter Ego trust) or the death of the survivor of you and your spouse (Joint Partner trust). Depending on how the trust is structured, you may be entitled to an immediate donation tax credit for property transferred to the trust if the trust is structured as a charitable remainder trust.

Alternatively, the trust itself may be also be eligible to claim a donation tax credit on any charitable gifting made directly by the trust subsequent to your death. However a trust may be more limited in its use of charitable donation credits since the one year carryback allowed for donations made in Wills is not available for trusts.

6) U.S. PERSONS

An Alter Ego or Joint Partner trust may not be an attractive estate planning tool for a U.S. citizen living in Canada. U.S. citizens who live in Canada are required to file both Canadian and U.S. tax returns. This dual reporting requirement could result in potentially double taxation where Alter Ego or Joint Partner trusts are used. If you are a U.S. persons (i.e. U.S. citizens or green card holders), it is strongly recommended that you consult with a qualified U.S. tax professional before you undertake to establish such a trust.

SO WHEN DOES IT MAKE SENSE TO USE AN ALTER EGO OR JOINT PARTNER TRUST?

The answer to this question depends on what is important to you. From a purely financial point of view, any probate tax savings should be weighed against any set up and on-going costs as well as the potential for a greater amount of income taxes payable at death where an Alter Ego or Joint Partner trust is used. In addition, if you use these trusts you will also miss out on the opportunity to create testamentary trusts as an income splitting tool for your beneficiaries.

You should also weigh the non-quantitative factors such as preserving your privacy, providing for the continuous management of your property, and protecting your assets from estate litigation against the possible loss of control of your assets if you use these trusts.

Factors that may favor the use of an Alter Ego trust or Joint Partner trust may include:

- i) if a significant value of assets are transferred into these trusts;
- ii) if you do not need to access the trust capital during your lifetime;
- iii) if you have assets in multiple jurisdiction;
- iv) if the trustee or a majority of the trustees reside in a province with a top marginal tax rate that is lower than your personal marginal tax rate;
- v) if you are in a second marriage and you want to provide for your spouse during her lifetime, but leave the residue of your assets to your own children after his/her death; and
- vi) if protecting your privacy, providing continuous management for your property or protecting your assets from estate litigation is important to you.

Factors that make the use of these trusts less attractive may include:

- i) if you are transferring assets of nominal value to the trust;
- ii) if you want to use testamentary trusts as an income splitting tool for your beneficiaries; and
- iii) if you want to retain control or flexibility over your assets.

As you can see, alter ego and joint partner trusts may not be for everyone. You should discuss your particular situation with a qualified legal or tax advisor to see if these trusts are right for you.

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