The Navigator

RBC WEALTH MANAGEMENT SERVICES

Alter Ego and Joint Partner Trusts

You should obtain professional advice from a qualified tax advisor before acting on any of the information in this article. This will ensure that your own circumstances have been properly considered and that action is taken on the latest information available.

The purpose of this article is to provide you with some basic information on alter ego and joint partner trusts, discuss some of their benefits and drawbacks, and outline some scenarios where the use of these trusts may be beneficial.

What are alter ego and joint partner trusts?

An alter ego trust is an inter-vivos trust created after 1999 by someone (the settlor) who was 65 years of age or older at the time the trust was created. The settlor must be entitled to receive all the income of the trust during his or her lifetime. In addition, no one but the settlor 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 or common-law 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 created after 1999 by a settlor who was 65 years of age or older at the time the trust was created. Under this trust, the settlor and their spouse are entitled to receive all the income of the trust that arises before the second to die. Also, no one except for the settlor and their spouse can receive or use the income or capital from the trust prior to the last to die.

In order to create an alter ego or a joint partner trust, the settlor and the trust must be a resident of Canada at the time the assets are transferred to the trust. In the case of a joint partner trust, the non-settlor spouse is not required to be a resident of Canada.

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 or a joint partner trust, your disposition price will be equal to your cost, namely $75,000, which means that you will have no immediate tax consequences. The alter ego or joint partner trust in this case will inherit your cost base (i.e. $75,000) for the purpose of determining the trust's tax consequences when the portfolio is subsequently disposed of by 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. You can elect to transfer assets into either one of these trusts on a fair market value basis if you so choose. For example, it may make sense for you to transfer your shares of a qualified small business corporation or a qualified farm property at its fair market value into these trusts since you can get a bump up in the fair market value and take advantage of your capital gains deduction. This election can be done on a property by property basis but for each property it is an all or nothing election in that you cannot choose a disposition value between your cost and the fair market value.

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The second difference between alter ego and joint partner trusts and other types of inter-vivos trusts is the 21-year deemed disposition rule. Generally an inter-vivos trust is deemed to have disposed of all its assets at fair market value every 21 years. The purpose behind this rule is to prevent a trust from accruing unrealized capital gains over a long period of time. However the 21-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 is the date of death of the last to die of the settlor and their 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?

You can transfer any kind of capital property to an alter ego or joint partner trust. These include assets such as stocks, bonds, and mutual funds, personal use assets such as your principal residence, and private company shares. However, you cannot transfer your RRSP or RRIF directly into these trusts unless the assets are deregistered first, which is generally not advisable since any amount withdrawn from an RRSP or RRIF will be taxable in the year that it is withdrawn. In addition, you cannot transfer inventory including raw land, goodwill or resource property into these trusts.

How are alter ego and joint partner trusts taxed?

The taxation of income and capital gains earned by an alter ego trust or joint partner trust depends on whether the settlor has any rights to the capital of the trust. If the settlor retains some right to access capital from the trust, or to revoke the trust and take the capital back, this will generally result in attribution of all income and capital gains back to the settlor. In the case of an alter ego trust, all income and capital gains are taxed on the settlor's tax return. It can be more complicated for a joint partner trust. If all of the capital were settled into the trust by only one of the spouses, then it is taxed on that settlor's return. Where both spouses 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.

Conversely, if the trust is structured so that the settlor does not have any access to capital, it is possible to avoid income attribution. In this case, the trust income and capital gains can be taxed in the trust at the highest applicable combined federal and provincial income tax rates.

You can transfer any kind of capital property to an alter ego or joint partner trust. These include assets such as stocks, bonds, and mutual funds, personal use assets such as your principal residence, and private company shares.

Although one of the requirements of an alter ego or joint partner trust is for the settlor or the spouses to be solely entitled to receive all of the income earned in any taxation year, it does not have to be paid out to any of them during the year. The income beneficiary/(ies) may have the option 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 option to not be paid the income must be that of the income beneficiary/(ies).

Alternatively, it is possible to pay the income to the beneficiary/(ies) and still have the income taxed in the trust, provided that an appropriate designation is made by the trust under certain provisions of the Income Tax Act. These rules are important when the purpose of the alter ego trust is to have the income earned by the trust taxed in a lower tax jurisdiction than where the settlor resides. This is discussed later, under the heading "advantages of an alter ego or joint partner trust".

Finally, when the settlor of an alter ego trust or the last to die of a joint 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 death. This will trigger capital gains or losses which will be subject to tax at the trust's highest applicable combined federal and provincial tax rate. The income is reported on the trust tax return, not the terminal return of the deceased settlor (this is true even when the attribution rules are applicable).

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. Assuming you contributed all of the assets into the joint partner trust, the income that may be allocated and taxed in the hands of your spouse will be restricted to the second generation income earned by the trust. This second generation income is the income earned on property acquired with income that was previously taxed either in your hands or at the trust level.

What are some of the advantages 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) Continuous management of your property
If your executor is required to probate your will, he or 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 or countries, your executor may be required to probate your will more than once in the various jurisdictions. 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 is a private document therefore will not be subject to public scrutiny.

4) Protection against estate litigation
It is generally more difficult for someone to challenge the validity of a trust than 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 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) Asset 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), or come to have creditors in the future, any structure chosen may be ineffective to protect against claims by these existing and future creditors.

It is essential that you speak to a qualified legal advisor regarding any asset protection options available to you.

7) 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 and is resident in a province with lower tax rates than where you reside, the income earned by the trust can be taxed in the trust at the tax rates in that province. 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 (as discussed in the previous section on how alter ego and joint partner trusts are taxed).

It should be noted, however, that a number of provinces have established general anti-avoidance tax rules that challenge the transfer of assets to an alter ego or joint partner trust resident in another province.

8) Reduction of OAS clawback
If you are subject to an 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 disadvantages 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 income

and capital gains earned on the assets that they inherit from you. 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 by that beneficiary as a result of the income earned on their inheritance. Instead of making a direct bequest to this beneficiary, you could have their inheritance held in a testamentary 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, 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 inter vivos trust and therefore, will 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 may lose control over those assets that you transfer to an alter ego or joint partner trust. Once the assets are transferred into the trust, the trustees will assume ownership and 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, you will lose the ability to use the trust to reduce the overall taxes paid as discussed previously (#7: Reduction of Income Tax) or not be able to achieve any asset protection. 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) Higher income taxes at death
Remember that except for 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 are subject to tax at your marginal tax rate. For assets that you have transferred to 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 last to die the case of a joint partner trust). The trust cannot, in this case, allocate any resulting capital gains to your estate. Instead the trust will have to pay 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 to the trust 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 last to die (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 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. person (U.S. citizen or green card holder) living in Canada. U.S. persons resident in Canada are required to file both Canadian and U.S. tax returns. This dual tax obligation could potentially result in double taxation where alter ego or joint partner trusts are used. If you are a U.S. person it is strongly recommended that you consult with a qualified U.S. tax professional before you 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 perspective, 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, probate tax savings;
- **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 their lifetime, but leave the residue of your assets to your own children after your spouse's 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 or you live in a province that has no probate taxes;
- **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 and/or tax advisor to see if these trusts are right for you.

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