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INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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Alter ego and joint partner trusts

You've taken time, possibly a lifetime, to accumulate your wealth. You want to ensure your estate is well-protected and that your assets are managed according to your wishes, both during your lifetime and beyond. An alter ego or joint spousal or common-law partner trust (referred to as a joint partner trust) can help you do just that by potentially minimizing probate tax, protecting your capital from potential undue influence and giving you peace of mind that your finances are being properly managed.

This article provides some basic information on alter ego and joint partner trusts, discusses some of their benefits and drawbacks, and outlines some scenarios where it may be beneficial to use trusts of this kind.

For the purposes of this article, it's assumed you're not a U.S. person (U.S. citizen, green-card holder or resident). If you're a U.S. person, you should consult a qualified cross-border tax professional before you establish these kinds of trusts. You can also ask your RBC advisor for a copy of the article on alter ego and joint partner trusts for U.S. persons for more information.

What is an alter ego and a joint partner trust?

An alter ego trust is an inter vivos trust created after 1999 by someone (the settlor) who's 65 years of age or over at the time they create the trust. The settlor must be entitled to receive the income of the trust while alive and no other person other than the settlor can receive or use income or capital from the trust during the settlor's lifetime.

If the settlor is age 65 and wishes to include their spouse or common-law partner as a beneficiary of the trust, they can use a joint partner trust. For the purposes of this article, any reference to a "spouse" includes a common-law partner. A joint partner trust differs from an alter ego trust in one respect. Under the terms of this trust, the settlor, in combination with their spouse, must be entitled to receive all income from the trust prior to the death of the second spouse. No one else can receive or use any income or capital from the trust before the death of the second spouse.

To create an alter ego or a joint partner trust, the settlor and the trust must be resident in Canada at the time the assets are transferred to the trust.

Since 2016, testamentary trusts generally no longer benefit from graduated tax rates. Graduated tax rates have been replaced with flat top-rate taxation that's currently used for most inter vivos trusts (i.e., taxed at the top personal marginal tax rate), making them less attractive from a tax perspective. In the absence of the favourable taxation that was previously available to testamentary trusts, estate planners may now wish to reconsider the benefits that inter vivos trusts, including alter ego and joint partner trusts, can provide as part of an estate plan.

Advantages of an alter ego or a joint partner trust

Alter ego or joint partner trusts may provide the following benefits (note that many of the advantages and benefits set out in the following sections do not apply in the province of Quebec):

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. Probate tax is usually payable as part of this process on the value of assets that form part of the estate. Probate tax varies across the provinces and territories. Assets transferred to an alter ego or a joint partner trust do not form part of a deceased's estate and therefore are not included in the calculation of probate tax.

Continuous management of property

If your executor is required to probate your Will, they may not be able to administer your estate until probate is granted. This may take some time. In addition, if you own assets, such as real estate, in different provinces or countries, your executor may be required to probate your Will in more than one jurisdiction. This can be both time consuming and costly. By transferring your property to an alter ego trust or a joint partner trust, you may be able to minimize disruption to the management of your assets on death since the trustees of your alter ego or joint partner trust will not need to obtain probate to administer the trust assets.

Privacy and confidentiality

If your Will is probated, it becomes a public document. Anyone can obtain a copy of your probated Will from the court. This may disclose both

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your testamentary intentions and the value of your estate. If you wish to keep this information private, you may want to consider transferring your assets to an alter ego or joint partner trust. The trust document that governs the administration of the trust is private and will not be subject to public scrutiny.

Protection from estate litigation

It may be more difficult to challenge the validity of a trust than a Will. In addition, a number of Canadian jurisdictions have laws enabling dependants to challenge the adequacy of the support provisions made for them in a Will but not from a valid trust. If you want to ensure your estate is distributed in accordance with your wishes, you may want to consider using an irrevocable trust. Note that a court may be able to set aside a transfer to a trust or rule that trust assets form part of the estate in certain extreme situations. For example, this may occur in cases involving a spouse or minor child.

Alternative to a power of attorney

A power of attorney allows the person you appoint as your attorney to assist you in managing your assets. If you transfer your assets to an alter ego trust, you could choose to appoint the same person as trustee to manage the trust assets. In certain situations, there can be advantages to using a trust instead of a power of attorney when you're planning for incapacity. For example, if you have assets in multiple jurisdictions, you may need multiple powers of attorney to meet the different legal requirements of those jurisdictions. If your assets are managed in a trust, foreign banks and financial institutions may be more likely to recognize the authority of the trustee to act on behalf of the trust.

A trust may also be a more effective than a power of attorney to manage assets in cases of diminished capacity. If you have a power of attorney, you can continue to manage your assets as long as you're mentally capable. However, during a period of declining mental health, you may make decisions related to your assets that you wouldn't otherwise make. You may be able to avoid this situation if you use an alter ego or joint partner trust and appoint someone other than yourself as the trustee. Note, however, that you'll no longer be able to deal with the assets that you transfer to the trust if you're not a trustee, so you must be comfortable with this aspect of your plan.

Asset protection

Trust assets may be protected from your creditors. This is because when you transfer an asset to a trust, you transfer ownership of the asset to the trustee. Since you no longer own the asset, it may not be available to your creditors. However, if you're the income and/or capital beneficiary of the trust, your creditors may be able to lay claim to your interest in the trust. In an alter ego or a joint partner trust, you (or your spouse in the case of a joint partner trust) must be entitled to receive all of the income of the trust. Therefore, these kinds of trusts may only provide a limited amount of asset protection. You may benefit from a higher level of asset protection if you're not named as a capital beneficiary of the trust or if you're not a trustee of the trust and the distribution of capital to you is entirely within the trustee's discretion.

It's important to note that if you transfer assets to a trust to avoid or defeat an existing creditor, or potential future creditors, whatever trust structure you choose may not protect you against the claims of such creditors.

It's essential to obtain advice from a qualified legal advisor regarding the asset protection options available to you.

Disadvantages of an alter ego or a joint partner trust

Before setting up an alter ego or a joint partner trust, you should consider some of the disadvantages associated with these types of trusts:

Cost and complexity

Setting up an alter ego or a joint partner trust involves legal fees. After the trust is established, you may also incur ongoing administration costs such as accounting and/or trustee fees. Consider the time commitment your trustee will need to make to administer the trust and file the necessary tax returns. This should also be a factor in your decision to set up the trust and in your choice of an appropriate trustee.

Control and flexibility

Once you transfer the assets into the trust, the trustees will assume ownership and control of these assets. You may be able to retain control of these assets if you appoint yourself as the sole or controlling trustee; however, you may not be able to achieve any asset protection, particularly if you're the capital beneficiary.

It's also important to be aware that once it's established, it's generally more difficult to change the terms of a trust, including the named contingent beneficiaries, than it is to change a Will. Changes made to the terms of the trust, as opposed to a Will, may also have tax consequences.

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Charitable donations

If you want to make charitable donations during your lifetime, you may want to set aside assets to carry out this intention. As discussed, an alter ego or a joint partner trust is 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) during your or your spouse's lifetime. Consequently, you will not be able to use trust assets to achieve your charitable objectives during your or your spouse's lifetime. You can, however, choose to donate the income or capital that you receive from these trusts to charity.

Your alter ego or joint partner trust can donate the trust property upon your death, or in the case of a joint partner trust, the death of the surviving spouse. You may be entitled to an immediate donation tax credit for the property you transfer to the trust if you structure the trust as a charitable remainder trust. Alternatively, the trust itself may also be eligible to claim a donation tax credit on any charitable donations made directly by the trust after your death. The charitable gift must be properly structured to ensure the amount paid to the charity by the trust is viewed as a gift and not as a payment in satisfaction of the charity's interest as a beneficiary of the trust. Unlike an estate, a gift of securities in-kind by the trust will not eliminate the capital gains realized as a result of the trust beneficiary's death. You should talk to a qualified tax advisor about how best to effect and structure a charitable gift by an alter ego or a joint partner trust.

What kind of assets can I transfer into an alter ego or a joint partner trust on a tax-deferred basis?

You can generally transfer any kind of "capital property" to an alter ego or a joint partner trust on a tax-deferred basis. Capital property is "depreciable property" and any property that if disposed of may result in a capital gain or a capital loss. An example of depreciable property is a building from which you derive rental income. Other types of capital property could include stocks, bonds, mutual funds, personal-use property such as your principal residence, and private company shares. You can't transfer non-capital property, such as inventory, into these trusts on a tax-deferred basis. Also, note that you can't transfer your RRSP or RRIF directly into these trusts unless you withdraw the assets first. This is generally not advisable since you'll pay tax on any amount you withdraw from your RRSP or RRIF in the year you make the withdrawal.

Taxation of alter ego and joint partner trusts

It's common that you, the settlor (and contributor) to an alter ego or a joint partner trust, will be a sole trustee and/or capital beneficiary of the trust. In such a situation, subsection 75(2) of the Income Tax Act (the super attribution rules) applies to the trust. If the super attribution rules apply, all income/losses and capital gains/losses earned in the trust are attributed back to you, the settlor/contributor, and taxed in your hands at your marginal tax rate.

Even if the super attribution rules don't apply to an alter ego trust or a joint partner trust, the income earned in the trust will generally be taxable in your or your spouse's hands. As a beneficiary of an alter ego or a joint partner trust, you must be entitled to receive all the income of the trust during your lifetime. This means all of the income earned by the trust each year must be paid or made payable to you, or to you and/or your spouse in the case of a joint partner trust. In general, the trust income paid or made payable to you will be taxed at your marginal tax rate. In the case of a joint partner trust, if the income paid or made payable to your spouse is traceable to property that you contributed to the trust, the income will be attributed back to you and taxed in your hands while you're alive.

When you, the settlor of an alter ego trust, or the last spouse of a joint partner trust passes away, the trust is deemed to have disposed of all of its property at its fair market value (FMV) on the date of death. Any taxable capital gains arising on your death, or in the case of a joint partner trust, on the death of the surviving spouse, will be taxable in the trust at the top marginal tax rate that applies to the trust. The trust will also have a deemed year-end at the date of death.

The effect of changes to the capital gains inclusion rate on alter ego and joint partner trusts

In 2024, the government increased the capital gains inclusion rate from 50% to 66.67% for capital gains realized by an individual that are above $250,000 and for all capital gains realized and taxed in a trust on or after June 25, 2024. This change impacts the taxation of capital gains earned by your alter ego or joint partner trust, particularly on your death, or on the death of the surviving spouse in the case of a joint partner trust.

As mentioned, it's common that the super attribution rules would apply to your alter ego or joint partner trust during your lifetime. If these rules apply to your trust, the capital gains earned in the trust are attributed back to you, the settlor/contributor of the trust, and taxed in your hands. You may be able to use your 50% inclusion rate on the first $250,000 of capital gains attributed to you annually.

Even if the super attribution rules don't apply to an alter ego trust or a joint partner trust, the income earned in the trust will generally be taxable in your or your spouse's hands. As a beneficiary of an alter ego or a joint partner trust, you must be entitled to receive all the income of the trust during your lifetime.

If the super attribution rules don't apply to your alter ego or joint partner trust, the trustee may be able to, pursuant to the terms of the trust, pay or make payable the taxable capital gain to you, or to you and your spouse in the case of a joint partner trust, and get a deduction on the trust tax return so that the taxable capital gain is not taxed in the trust and subject to the 66.67% inclusion rate. In this case, you or your spouse may be able to benefit from the 50% inclusion rate for the first $250,000 of capital gains.

On your death or on the surviving spouse's death, any capital gains realized as a result of the deemed disposition of trust assets will be taxed in the alter ego or joint partner trust. The capital gains can't be attributed back to you, the settlor/contributor, even if the super attribution rules applied to the trust during your lifetime. They also can't be allocated to the trust beneficiary and taxed on their terminal tax return. This means the capital gains realized as a result of your death, or the surviving spouse's death, will be subject to the 66.67% inclusion rate.

The trustee of your alter ego or joint partner trust may want to consider managing the capital gains during your lifetime, and your spouse's lifetime in the case of a joint partner trust, to reduce the gains subject to the higher tax at death. If the trust document provides for a charitable gift on your death, or the surviving spouse's death in the case of a joint partner trust, the trust might be able to claim a donation tax credit and use it to reduce the taxes payable on the capital gains realized as a result of death.

Taxation of foreign income and potential for double tax

If the super attribution rules apply to your alter ego or joint partner trust, you should be aware of the potential for double tax to occur where the trust earns foreign income that's subject to foreign withholding tax.

In general, if you earn foreign income that's subject to foreign withholding tax, you may be able to claim a foreign tax credit on your Canadian tax return for the taxes paid to the foreign jurisdiction and reduce your Canadian taxes payable on that foreign income. This may avoid double taxation of this income.

In general, if you earn foreign income that's subject to foreign withholding tax, you may be able to claim a foreign tax credit on your Canadian tax return for the taxes paid to the foreign jurisdiction and reduce your Canadian taxes payable on that foreign income. This may avoid double taxation of this income.

Generally, a foreign tax credit may only be deducted by the taxpayer who paid the foreign withholding tax when they earned the foreign income. However, if a trust allocates foreign income earned to a beneficiary, the beneficiary is deemed to have paid the foreign withholding tax on that income and is able to claim a foreign tax credit for the foreign taxes paid.

Where the super attribution rules apply to a trust, the foreign income earned by the trust is deemed to be the income of the settlor of or contributor to the trust. The income is taxed in the settlor's/contributor's hands pursuant to the super attribution rules and not because the trust has allocated this income to them as a beneficiary of the trust. The super attribution rules do not attribute the foreign taxes paid on this income to the settlor/contributor. Since the trust is the one that paid the foreign tax, the settlor/contributor is not able to claim a foreign tax credit in respect of the foreign tax paid by the trust. As such, there generally will not be an ability to recover the foreign taxes paid, resulting in the potential for double tax.

If the super attribution rules apply to your alter ego or joint partner trust, you should consider this potential for double tax when choosing your investments.

Alternative minimum tax (AMT)

Your alter ego or joint partner trust may be subject to AMT during your or your spouse's lifetime. AMT is a parallel tax calculation, designed to prevent individuals and certain trusts from paying little or no tax by limiting the tax advantages they could receive in a year through certain tax incentives. A qualified tax advisor can help you determine if your alter ego trust or joint partner trust will have an AMT liability for a given tax year. AMT does not apply to your alter ego or joint partner trust in the year of your death or, in the case of a joint partner trust, the year of the surviving spouse's death.

How are alter ego and joint partner trusts different from other inter vivos trusts?

Alter ego and joint partner trusts differ from other types of inter vivos trusts in a few important ways.

First, when you transfer property to an inter vivos trust, you're generally deemed to have disposed of the property at its FMV. This could result in immediate tax consequences. Alter ego and joint partner trusts can be an appealing option because of this ability to transfer capital property to the trust on a tax-deferred basis. Alternatively, you could elect to transfer assets into either of these trusts at FMV. You may wish to do this, for example, if you own shares of a qualified small business corporation or a qualified farm property. This would enable you to take advantage of your capital gains deduction and bump up the adjusted cost base (ACB) of these assets. You can make this election to transfer property to the trust at the ACB or FMV on a property-by-property basis; however, for each property, it's an all or nothing election. This means you must either transfer the property at your ACB or at FMV and can't choose a disposition value between your ACB and the FMV.

Another difference between alter ego and joint partner trusts and other types of inter vivos trusts is the application of the 21-year deemed disposition rule. Generally, inter vivos trusts are deemed to have disposed of their property at FMV every 21 years. This rule prevents a trust from accruing unrealized capital gains over a long period of time. 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.

Should you use an alter ego or a joint partner trust?

If you're considering setting up either an alter ego trust or a joint partner trust, weigh the potential savings in probate tax against the set-up costs of these kinds of trusts and the ongoing administration expenses that may be involved. As discussed, take into consideration the income taxes that may arise on your death, or on the death of the surviving spouse in the case of a joint partner trust. Other benefits to consider include preserving your privacy, providing continuity in the management of your property, and protecting your assets from estate litigation. Consider these potential advantages against the possibility that you may lose control of the assets you transfer into these trusts.

You may wish to consider using an alter ego or a joint partner trust in the following cases:

1. You own assets of significant value which may be subject to probate tax;
2. You do not need to access the trust capital during your lifetime but you're willing to pay tax on the income earned on the assets;
3. You have assets in multiple jurisdictions;
4. You're in a second marriage and wish to provide for your spouse during their lifetime but to leave the remaining assets to your own children after your spouse's death; and/or
5. Protecting your privacy, providing continuous management for your property, or protecting your assets from estate litigation is important to you.

Alter ego and joint partner trusts may be less attractive in the following cases:

1. The assets you wish to transfer to the trust are of nominal value;
2. You live in a jurisdiction that has no or minimal probate tax; and/or
3. You want to retain control over your assets.

Consult a qualified legal and/or tax professional to determine if an alter ego or a joint partner trust is appropriate for your circumstances.

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