# *Alter Ego* and Joint Partner Trusts: Some Issues - Part I

by David Louis, B. Com., J.D., C.A., Tax Partner
Minden Gross LLP, a member of MERITAS Law Firms Worldwide.

*(*This release is based on an article published in Tax Notes #536, September 2007, CCH Canadian Limited)*

___________

***This article is based on a section of* Tax and Family Business Succession Planning, Second Edition, *by David Louis and Samantha Prasad, to be published by CCH this fall.***

*Alter ego* and joint partner trusts can have a number of advantages. Of course, the most well known is probate fee reduction. While Ontario weighs in with the highest rate (1.5%), the *Granovsky***[i]** case sanctions multiple wills in that province; and the use of these wills substitutes to protect against dependent's relief claims that are also problematic there. But *alter ego* and joint partner trusts may enjoy greater popularity in other provinces, such as British Columbia where probate taxes are only a smidge lower (1.4%) than in Ontario. In addition these trusts offer the advantage of confidentiality and can afford a certain degree of creditor and marital protection. Finally, they can offer administrative advantages and can be an effective alternative to a power of attorney.

However, the use of *alter ego* and joint partner trusts can also have some drawbacks. (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 time goes by, the list of technical issues has increased, as practitioners delve into the intricacies of these vehicles:

- **Amending Formulae.** As discussed in Chapter 3, 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. Also, as noted in Chapter 3, Doc. No. 2001-0111303**[ii]**, involved a ruling pertaining to the addition of a beneficiary pursuant to an amending formula in the trust. While the CRA ruled that the amendment would not, in and by itself, result in a disposition of any property of the trust, it also indicated that the variation would result in the disposition of a portion of each beneficiary's interest in the trust at the time the variation is made**[iii]**.

  If this is the CRA's view, one would think that similar approach should therefore apply to an amendment adding a beneficiary to an *alter ego* or joint partner trust. Query, however, whether the CRA would be motivated to attack an *alter ego* or joint partner trust with fundamental amendments made pursuant to an amending clause. 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).

- **Loss of Low Tax Brackets**. 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 this is that these trusts reduce provincial probate fees while increasing federal income tax.
- **Capital Gains Exemption.** Spouse and other testamentary trusts have access to the capital gains exemption by virtue of subsection 110.6(12) but *alter ego* and joint partner trusts do not.

- **Registration "Formalities".** It is quite likely that assets should 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. Similar issues will arise if an *alter ego* or joint partner trust is desired for creditor protection: failure to register assets in the name of the trustee may leave assets with greater vulnerability to creditor claims.
- **Reversionary Trust Rules/Interprovincial Planning.** If a taxpayer wants to be a capital beneficiary of the trust, absent careful planning, any potential inter-provincial tax planning opportunity (i.e., shifting assets to a taxpayer - i.e., the trust - in a lower tax rate province such that income and gains will be taxed in that taxpayer's hands) is likely unavailable.

  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. In order for subsection 75(2) not to apply, the trust should be irrevocable and under no circumstances (other than by operation of law on the failure of the trust) should it be possible for the property to revert to the settlor. For reasons discussed above, this is a suboptimal feature which should be considered carefully.

  Besides this, other constraints of subsection 75(2) would have to be met; for further discussion, reference should be made to Chapter 2. Of course, it would also be necessary to establish that the trust is resident in the province, which would presumably entail the appointment of local trustees and meeting other requirements in this respect**[iv]**. (Note: although a requirement of an *alter ego*/joint partner trust is that the settlor/spouse must be entitled to all of the income, elections can be made under subsections 104(13.1) and (13.2) to tax the income at the trust level.) If, however, the trust were resident in a low-tax province, in addition to benefits relating to ongoing income, tax may be reduced in respect of deemed dispositions on death.

  Even though subsection 75(2) may apply to an *alter ego* or joint partner trust, it is the CRA's position that a T3 return must be filed, including schedule 9 (allocations) and T3 slips. This requirement was stated by the CRA in a Technical Interpretation released July 11, 2002, Doc. 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 [75(2) applies to an *alter ego* or joint partner trust].**[v]**

- **Effect of subsection 75(2) to the individual.** In most cases, income earned by an *alter ego* or joint partner trust will be taxable to the settlor rather than the trust itself pursuant to subsection 75(2). This provision is very generally worded, requiring only that income or loss from the property (or substituted property), and taxable capital gains or allowable capital losses from the disposition of property (or substituted property) is taxable to the settlor. However, this provision, in itself, provides little guidance to the intricacies of tax issues that may arise. In Technical Interpretation No. 2006-0216491E5, July 11, 2007, the CRA was asked how Regulation 1100(11), which restricts CCA to net rental income of the taxpayer, would apply where both the settlor and the *alter ego* trust earn rental income – i.e., would the settlor be able to aggregate the *alter ego* trust's net rental income with his or her own? The CRA indicated that the CCA limitation for computing the trust's income to be attributed to the individual is computed separately from the CCA limitation on property owned by the individual directly (Regulation 1100(15) would apply in a similar manner). Implicit in this interpretation is that the *alter-ego* trust is a separate taxpayer, whose income is attributed to the settlor pursuant to subsection 75(2). If this is the case, query, for example, whether provisions such as restricted farm loss (section 31) would apply separately to the alter-ego trust.

- **Acquisition of Control Issues – Transfer to *Alter Ego* or Joint Partner Trust.** When control of a corporation is acquired by a trust, control will be considered to have been acquired by the trustees of the trust.**[vi]** If control is transferred to or from an estate, special rules in paragraph 256(7)(a) which specifically apply to estates may exempt the provisions that are triggered by an acquisition of control (loss streaming, deemed year-end, etc.). These rules do not apply to *alter ego* or joint partner trusts; therefore, the transfer of control to such a trust could trigger such provisions. However, other exceptions in that paragraph pertaining to related person status, may apply, e.g., where the trustee of an *alter ego* or joint partner trust is related to the transferor of a control block of shares. For further discussion, see Chapter 8. It therefore appears that these particular exceptions must be met when control of a corporation is transferred to an *alter ego* or joint partner trust.

Continued next month.

---

**[i]** *Granovsky Estate* v. *Ontario*, (1998) 156 DLR (4th) 557 (Ont. Gen. Div.).

**[ii]** November 27th, 2002.

**[iii]** The CRA also indicated that the value of each beneficiary's interest in the trust at a particular point of time will approximate a proportionate share of the fair market value of the total of the trust property at the time.

**[iv]** In addition, provincial anti-avoidance rules should be considered (Quebec has introduced an anti-avoidance legislation). For the CRA's policies in respect of the residence of a trust, see Interpretation Bulletin IT-447.

**[v]** The position that a return is required was reiterated at the 2006 STEP Conference. See Technical Interpretation No. 2006-0185561C6, September 11, 2006.

The APFF followed up on the above remarks at its 2006 CRA round table, asking the CRA to confirm this position, as well as asking how a loss of a trust can be allocated to the transferor, and whether the CRA could apply penalties for the non-filing of the T3 return when all of its income is subject to subsection 75(2). The CRA reiterated its long-standing position that a T3 return is both a return of income and an information return and confirmed the position expressed at the STEP round table (and that Document No. 95039335 no longer represented the CRA's position in this regard). The CRA indicated that the "presumptions outlined in subsection 75(2). . . permit the transferor . . . to take advantage of any allowable capital loss in his/her return of income" indicating that in such situations the loss should be reported in parentheses in the appropriate box on the T3 slip. Finally, the CRA's view is that the obligation to file a T3 Return where subsection 75(2) applies as an information return per section 204 of the regulations, is legally supported by section 221 of the Act. Consequently, "the CRA would be in a position to apply the subsection 162(7) penalty." [This is the $25-per-day penalty for failure to file an information return, with a maximum penalty of $2,500.] See Doc No. 2006-0196201C6, October 6, 2006.

**[vi]** See *MNR* v. *Consolidated Holding Company Ltd.*, 72 DTC 6007 (SCC).