Alter Ego and Joint Partner Trusts: Some Issues - Part II

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 #537, October 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 later this fall.

This is a continuation of last month's article, in which we surveyed some issues pertaining to *alter ego* and joint partner trusts, including amending formulae, reversionary trust rules**[1]**, loss of low brackets and the capital gains exemption and so on. This month's article concludes our survey.

- **Charitable Donations.** A charitable donation made in one's will can be applied against the tax exposure due to deemed dispositions on death. In addition, the donation limit for the year of death is increased from 75% to 100% of income and qualifies for a carry-back**[2]**. Assuming that an *alter ego* or joint partner trust contains a power of encroachment, the ability to use a charitable tax credit against the deemed realization on death is available only if gift is made to the charity in the taxation year in which death occurs**[3]**. (Unlike the special treatment available for a donation made in a will, the charitable tax credit in an *alter ego* or joint partner trust cannot be carried back – it can only be carried forward; because of the basic requirements of *alter ego*/joint partner trusts, donations cannot be made prior to death of the settlor/surviving spouse.) Further, depending on the drafting of the trust, issues may arise as to whether the transfer to the charity is voluntary or is a distribution in satisfaction of the charity's capital interest in the trust - governed by subsection 107(2) rather than treated as a charitable donation**[4]**. It has been stated that, in view of these issues, charitable gifts should be made by will rather than in an *alter ego* or joint partner trust; however, this is not advantageous if an objective of the donation is to shelter the deemed disposition on death of assets placed in these trusts. (If an *alter ego* or joint partner trust does not contain a power of encroachment, it might qualify as a charitable remainder trust; however, the lack of a power of encroachment may not be acceptable. In addition, the taxation of a charitable remainder trust differs from a normal *post-mortem* gift in that the charitable donation is current and is subject to a present-value calculation.)
- **Trustee Issues.** Where it is desirable to have third-party trustees (e.g., where there are creditor considerations), the settlor may lose effective control of the assets. This could especially be the case if the trustees are concerned with their fiduciary duties to other beneficiaries of the trust. For example, if the trustees are given the power to make discretionary distributions of capital to the settlor, they may be concerned that making such distributions could put them in jeopardy of proceedings against them by other beneficiaries. While the settlor may provide an indemnity, query whether his or her assets will be sufficient, especially if the capital distributions are made to meet personal and living expenses. Unless the settlor can revoke the trust, similar considerations could apply if the settlor desires that the trustees "unwind" the arrangement, e.g., by distributing the assets of the trust and transferring them to a new *alter ego*/joint partner trust with different beneficiaries.
- **Acquisition of Control Issues - Change of Trustees.** As discussed in Chapter 3, a change of trustees could result in an acquisition of control of a corporation if control is held by the trust, particularly if the new trustee is unrelated to the previous trustee**[5]**. If so, loss streaming rules would apply, there would be a deemed year end, and so on. This could be particularly problematic with respect to *alter ego* and joint partner trusts, where the original trustee is the settlor and/or spouse: when the original trustees pass away, the appointment of an unrelated trustee would appear to be problematic.

- **Property Transfer Tax.** Depending on the province, there may be an issue as to whether land/property transfer tax may apply if real estate is transferred to an *alter ego* or joint partner trust. Such transfer tax may be based on the value of consideration and thus, the issue may arise if there is a mortgage on the property which is being assumed by the *alter ego* or joint partner trust.
- **Emigration.** An interest in *alter-ego* or joint partner trust is normally excluded from the deemed disposition rules on becoming a non-resident by virtue of being an excluded right or interest pursuant to subparagraph 128.1(4)(b)(iii) and paragraph (j) of the definition of "excluded right or interest" in subsection 128.1(10). However, paragraph 104(4)(a.3) provides for a deemed disposition by the trust where it is reasonable to conclude that property was transferred to such a trust in anticipation of the taxpayer subsequently ceasing to be resident in Canada.
- ***Post-mortem* Planning.** In respect of *post-mortem* tax planning procedures, an *alter ego* or joint partner trust is similar to a spouse trust: rather than the mechanism of subsection 164(6) applying (i.e., a "one year carry back" from the estate to the decedent), the mechanism for triggering a *post-mortem* capital loss in such a trust relates to a single entity (i.e., the trust itself) and is the normal three-year carry back. In view of this, it is suggested that the trust should be drafted to allow for the possibility of the trust continuing after the death of the settlor so as to enable such a carry back.

  In addition, *post-mortem* procedures themselves may differ. Similar to the discussion in Chapter 12, at time of writing, the subsection 40(3.61) exemption to the stop-loss rules has not been amended to deal with these trusts. Therefore, the affiliation rules are relevant and considerations similar to those discussed in Chapter 12 in respect to spouse trusts may apply. Furthermore, unless special provisions are made in the trust**[6]**, the use of the paragraph 88(1)(d) bump may be greatly restricted: paragraph 88(1)(d.3) does not apply to deem control to have been acquired from an arm's-length individual on the death of the beneficiary under an *alter ego*, or joint partner trust. Instead, in determining the adjusted cost base of shares of a corporation held by these trusts, one must look to when control was last acquired from an arm's length person; this could be a very modest amount (if any).
- **Stop-Loss Grandfathering.** Shares transferred to an *alter ego* or joint partner trust will no longer qualify for grandfathering from the stop-loss rules in section 112 pertaining to the capital dividend account (i.e., relating to qualifying pre-April 27, 1995 arrangements).
- **Principal Residence Exemption.** The principal residence exemption can be claimed by a trust, including an *alter ego* or joint partner trust. However, if such a designation is made, there are restrictions on beneficiaries and related persons claiming separate exemptions, which should be reviewed carefully. Each beneficiary who "ordinarily inhabits" the home, or has a spouse, former spouse, or child who so uses it will be a "specified beneficiary". If the exemption is claimed by the trust, a specified beneficiary will not be able to claim a second exemption**[7]**.

  Also restricted from claiming a separate exemption are a specified beneficiary's spouse (unless legally separated) or single child under 18. Further, it seems that if a specified beneficiary has not attained the age of 18 and is single, a second principal residence exemption will not be available to the beneficiary's parents**[8]**, i.e., if the exemption is claimed by the trust.
- **Association Rules – Deemed Ownership by Surviving Spouse.** The ownership of shares by the surviving spouse may often be advantageous in respect of the association rules. In this respect, it should be noted that there is a special rule which applies in the case of a testamentary spouse trust**[9]** whereby the surviving spouse is deemed to own the shares in the trust, provided that the spouse's share of income or capital depends on the exercise (or failure to exercise) of any discretionary power. However, this rule does not appear to apply to an *alter ego* or joint partner trust.

- **Debt Forgiveness.** For the purpose of the debt forgiveness rules, a settlement of indebtedness will not occur if by way of "bequest or inheritance"**[10]**. It is not clear whether debt forgiveness in an *alter ego* or joint partner trust will qualify for this exception.
- **Rights or Things.** An *alter ego* or joint partner trust will not be eligible for the special treatment relating to "rights or things" in subsection 70(2) *et seq*. Although some qualifying items are germane only to individuals (e.g., unpaid bonuses, unused vacation leave credits), others could be applicable to such trusts, e.g., unpaid dividends or unmatured bond bonus coupons.
- **GST.** The transfer of property from a decedent to an estate is not a supply, and therefore GST does not apply. However, section 268 of the *Excise Tax Act* provides that, where property is settled by a person on an *inter vivos* trust, for GST purposes, the transfer is treated as a supply of the property by the person to the trust, and that the consideration for the sale is equal to the amount determined for income tax purposes to be the proceeds of disposition of the property. Since there will typically be a rollover into an *alter ego* or joint partner trust, this would appear to be based on the cost amount of the property to the transferor. Of course, the transfer may well be an exempt supply, such as the transfer of shares or other financial instruments, or certain used residential complexes.
- **US Issues.** Certain double-tax issues may result if such trusts are used as an estate planning tool for a Canadian resident who is also a US citizen.**[11]** In addition, there are a number of traps for US *situs* assets. For example, it does not appear that the foreign tax credit for US estate taxes (allowed to the extent of the Canadian federal taxes arising on US source income in the year of death) per paragraph 6 of Article XXIX B of the Canada-US Treaty will be available. Therefore US property on which estate tax may be exigible should not be transferred to such trusts.
- **Two Pots of Assets?** Either deliberately or otherwise, it is possible that the settlor will have personal assets/income. If so, there could be added complexities. For example, the settlor may have terminal period losses, and the trust may have gains resultant from the deemed disposition**[12]**. It is also possible that there could be similar issues prior to death; however, normally income and loss would be attributed to the settlor pursuant to subsection 75(2).
- **Other Tax Disadvantages.** An *alter ego* or joint partner trust must select a calendar year-end; this is not the case with a testamentary trust. These trusts must make quarterly tax instalments; again, this is not the case with a testamentary trust. Unlike a testamentary trust, an *alter ego* or joint partner trust is not entitled to the $40,000 alternative minimum tax exemption.**[13]**
- **Accounting, Legal, and Trustee Fees.** An *alter ego* or joint partner trust will entail keeping accounting records for the trust. As discussed last month, the CRA's position is that annual T3 tax returns are required even if all of the income is taxable to the settlor pursuant to subsection 75(2). There will also be trustee fees if a professional trustee is used. There will be legal fees in establishing the trust which will vary with the degree of customization required. As can be seen by the forgeoing discussion, *alter ego* and joint partner trusts can raise some intricate and difficult issues, especially when marital, creditor protection, *post-mortem* planning, charitable donations and the like are in play. It is suggested that these issues would be commonplace in the *milieu* of succession planning for the successful business.
- **The X Factor.** For some clients, there may be a very real possibility that the relationship between the settlor and the *alter ego*/joint partner trust may become hopelessly muddled because the client does not respect or understand the significance of creating and maintaining the trust. As mentioned earlier, a client may forget to register new assets. If it is not clear that the assets are held by the *alter ego*/joint partner trust, will they end up in the estate of the individual, rather than the trust? If so, perhaps a will should nonetheless be prepared, e.g., as a failsafe mechanism to guard against an intestacy. Worse still, could the assets end up being governed by a will which the individual thought was replaced by the trust – e.g., with the "wrong beneficiaries"? As noted previously, the

> CRA's position is that, even if subsection 75(2) applies to the trust, T3 returns must be filed annually and has indicated that penalties will apply if this is not done. This might not become apparent until income is to be reported by the trust, e.g., on death. Will probate fees be replaced by tax penalties?

In Ontario, at least, in view of the fact that the *Granovsky* case specifically sanctions the use of multiple wills, the above-mentioned technical deficiencies, along with problems with respect to avoiding dependents' relief legislation have made *alter ego* and joint partner trusts something of a rarity. (In other provinces, e.g., British Columbia, these will substitutes may be more popular.) However, they may be used where there is a specific advantage over wills. It is also submitted that they may be helpful in the succession planning process because of protection against family law claims. However, the drafter will have to become familiar with a myriad of tax pitfalls and traps.

---

[1] In late August, STEP released the text of the round table at its 2007 STEP national conference. In question 6, the CRA indicated that, where a trust pays foreign tax on foreign source income which is attributed to an individual (the "transferor") by virtue of subsections 75(2) (which is likely to apply in the case of an *alter ego* or joint partner trust), 56(4.1), 74.1(1) or 74.1(2), the transferor cannot claim the foreign tax credit because there is no mechanism to allow the tax paid by the trust as having been paid by the transferor. (Subsection 126(1) requires that non-business foreign income tax be paid by the taxpayer claiming the foreign tax credit.) However, a deduction under subsections 20(11) and (12) may apply.

[2] The donation limit for the preceding year is also 100%.

[3] The transfer of property in satisfaction of a charity's income interest cannot be deducted against income arising from the deemed realization of capital gains of the trust under subsection 104(4).

[4] The CRA's view as to the issue of whether a donation or distribution is made appears to be that it is a question of fact which depends upon the specific wording of the trust agreement and the intentions of the trustees. Where the trust agreement empowers the trustees to make a gift and the trustees exercise this power, it would be appropriate for subsection 118.1(3) (gift) to apply. On the other hand, where the charity is an income beneficiary and a distribution is made out of the trust's income, subsection 104(6) would be the relevant provision, so that the deduction against deemed capital gains is restricted. (In particular, see Technical interpretation 2000-0056625, dated April 4, 2001.) For further discussion of these issues, see *Alter ego* Trusts/Joint Partner Trusts, E. Hoffstein, 2004 OC p.12A:19 *et seq*. (see also ¶6336 of *Canadian Estate Planning Guide*, CCH Canadian Limited). Hopefully, if the terms of an *alter ego* trust grant the trustees a power to encroach in favour of the settlor and if they are given full discretion as to the charity to be benefited and the amount to be transferred, the transfer would be accepted by the CRA as having been voluntary. However, Hoffstein states that there is no "bright line" test to determine whether a transfer from an *alter ego* or a joint partner trust to a charity will result in a charitable tax credit and that it is not entirely clear that a transfer from an *alter ego* or joint partner trust will necessarily be treated as a charitable gift simply because the inclusion of a power of encroachment in favour of a life tenant arguably renders the transfer to the charity discretionary. The issue of whether a gift or distribution is made is reminiscent of whether, for the purposes of the *Family Law Act* (Ontario), the distribution of property to a married beneficiary of a discretionary family trust (in itself) constitutes a gift after marriage, so as to be excluded from net family property. While some family lawyers believe this to be the case, it appears that the preponderant view is that it is not.

[5] As discussed, where there is a change of trustees, it is not clear that the saving provisions in subsection 267(7) pertaining to related persons apply.

[6] Similar to the situation pointed out in the notes to Chapter 12, the trust could "call for" a distribution of controlling shares as a result of death, so that there would be an acquisition of control as a consequence of death – see the discussion of Document No. 2000-0017625.

[7] Paragraph (f) of the definition of "principal residence" in section 54 provides that a property designated as a principal residence by a trust under paragraph (c.1) of that definition will be deemed to have been designated as a principal residence for each specified beneficiary of the trust for the calendar year ending in that year.

[8] Or a sibling, if single and under 18.

[9] See clause 256(1.2)(f)(i)(A).

[10] See paragraph 80(2) (a).

[11] For further discussion, reference should be made to *Alter Ego* Trusts/Joint Partner Trusts, E. Hoffstein, 2004 OC p.12A:25.

[12] Per an earlier note, subsection 75(2) does not apply to the deemed disposition on death pursuant paragraph 104(4)(a).

[**13]** See "High Net Worth/Cross-Border Personal Tax Planning – Recent Developments of Importance", Rosanne Rocchi, on the Miller Thomson website, www.millerthomson.com.