Tax & Estate

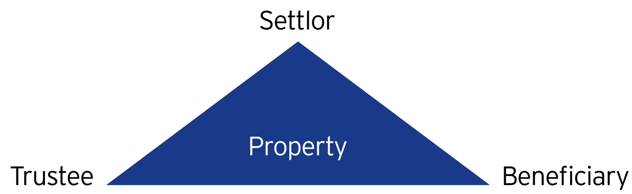
Tax planning using alter ego and joint partner trusts

More and more, seniors are looking for alternatives to estate planning traditionally limited to Wills and powers of attorney. They want options to help them protect and pass along assets they have built up over their lifetime. If you are looking for flexibility and control in planning your estate, alter ego and joint partner trusts may be worth considering. The following describes some of the features they can provide in structuring your estate and controlling the future use of your property.

How they work

Alter ego and joint partner trusts are *inter vivos* trusts as they are set up during the lifetime of the settlor. (A settlor is a term used to refer to someone who has established a trust.)

A trust describes a property relationship where those controlling the property may be separate from those entitled to that property. The diagram below shows how these particular trusts are structured. An alter ego trust is set up for the benefit of one person, while a joint partner trust is designed for a couple. The trustee becomes the legal owner of the assets in the trust, while the settlor remains entitled to the income and capital, and any income taxes arising out of the holdings. The settlor may act as the original trustee, but the trust document should include a provision for a substitute trustee to be appointed just in case the settlor is incapacitated or dies. On the death of the settlor (or the later death of the settlor and partner under a joint partner trust), the trustee can distribute the assets to one or more residual beneficiaries.



When to use these trusts

- If you are over 65 years old
- If you wish to continue to receive all of the income from the trust until your death (or the death of the second of two partners[†] in the case of a joint partner trust)
- If you have beneficiaries who may need immediate access to your assets upon death

[†] The term "partners" is used throughout this *InfoPage* and refers to legally married spouses and common-law partners of the same or opposite sex.

Why consider these trusts?

There are estate-planning aspects of these trusts that can be beneficial. Following is a brief overview of some of the advantages of using them in combination with a Will or as an alternative for incapacity planning.

Trusts combined with Wills

An alter ego or joint partner trust can be used as an alternative to your Will, or in combination with it and other legal documents to ensure assets are handled according to your wishes. There are a number of benefits to this, including avoiding probate and ensuring assets are distributed as originally intended. A Will is still necessary because you may have assets that are not included in the trust or you may acquire assets after establishing the trust.

For more information relating to the probate process, please see our *Tax & Estate InfoPage* titled *Probate planning*.

Save time and eliminate probate fees

Assets held by an alter ego or joint partner trust will not be included in your estate. Legally, the trustee owns the assets held in the trust, and following death, the trustee can distribute the assets to the residual beneficiaries according to the trust document. There is no need to go to court to obtain probate or letters of administration, and no probate fees have to be paid. The amount that will be saved on probate fees depends on where you live as fees vary between provinces. They are usually based on the value of the estate. If you have assets in more than one province or country, it may be necessary to apply for probate in each jurisdiction.

For more information about incapacity planning, please refer to our *Tax & Estate InfoPage* titled *Incapacity – Planning ahead helps*.

Ensure estate liquidity and continuity

The trustee of the alter ego or joint partner trust can immediately access the assets in the trust and distribute these assets to the trust's beneficiaries. This can be a benefit to your heirs as it can be an expensive and slow process to have a Will probated. Generally, upon a person's death, heirs may have limited access to any money held in bank accounts until the deceased's Will has been probated. This can take several weeks or even months to complete. During this time, the deceased's family may not have sufficient funds for day-to-day living expenses or bills. Also, if the deceased owned a business, delays in obtaining probate may interfere with day-to-day management, and this could threaten its continuing existence.

Protect against estate litigation

Property held personally generally flows into your estate at death, and could be subject to claims of lifetime creditors. As well, there are provincial laws that may allow a dissatisfied spouse, child or other dependent to seek support from an estate, and in some provinces to apply for a redistribution of the estate assets all together. By comparison, property in an alter ego or joint partner trust is a degree removed from such claims. A well-structured plan can be expected to escape all such claims, except in the most extraordinary circumstances.

Trusts as alternatives in incapacity planning

Alter ego or joint partner trusts can be used as alternatives to traditional incapacity documents and powers of attorney. (These are also referred to as representation agreements in British Columbia and mandates in the event of incapacity in Quebec.) If you have not executed such a document and become incapacitated, a costly court process may be necessary to make decisions about your personal affairs and manage your property, even if you have a spouse or common-law partner.

The benefit to using a trust is that you can avoid delays in appointing a substitute decision-maker and ensure continuity of asset management. Plus, incapacity documentation can often contain only a brief description of the duties and powers of the representative. On the other hand, the trust agreement very clearly sets out the duties and powers of the trustee. The trustee's powers may extend through incapacity and, unlike powers of attorney, continue after the settlor's death. Assets held in the trust will be managed by the trustee and can include assets located in more than one province, whereas a power of attorney may not be easily acted upon outside your home province.

Strategically managing capital gains and losses

An alter ego or joint partner trust is a separate taxable entity. Capital gains and losses that are deemed to occur on death of the settlor or partner cannot be netted against capital gains and losses of the trust. For this reason, the initial choice of assets settled into the trust must be carefully considered. As well, the continuous monitoring of all capital assets is an important aspect of ongoing trust management.

Income tax issues

When you transfer property to a trust, it's generally considered a sale and results in immediate tax on any capital gains. However, alter ego and joint partner trusts are an exception to this rule. You may transfer assets to the trust and will not have to pay taxes until the trust sells the assets or upon your death (or your partner's later death under a joint partner trust). Income (including capital gains) earned by the trust is taxed to the settlor or to the surviving partner after the settlor's death.

New rules to apply upon death

As a result of the changes introduced with the 2014 Federal Budget, a new deeming provision results in the trust's accrued capital gains to be payable to the deceased's life interest trust beneficiary. In an alter ego or joint partner trust arrangement, the settlor will be required to report the income created by the deeming provision, potentially creating a large income tax inclusion upon his or her death. These rules are to apply as of January 1, 2016, and they may create financial hardship in respect to the estate of the deceased.

Make the best use of capital gains exemptions

Under certain circumstances, it may be a good idea to transfer assets at fair market value to an alter ego or joint partner trust in order to use capital gains exemptions. For example, you may want to take advantage of the lifetime capital gains exemption on qualified small business corporation shares or farm property. It cannot be used once assets are in the trust. On the other hand, your principal residence can generally be transferred into an alter ego or joint partner trust without losing out on the principal residence exemption.

What happens if the trust runs for longer than 21 years?

For most trusts, assets are subject to a deemed disposition 21 years after the trust is created, and every 21 years after that. This means that the trust has to pay tax on any accrued capital gains on each 21-year anniversary. For the alter ego and joint partner trusts, the first deemed realization can be deferred until the later death of the settlor and partner, with the 21-year rule only applying from that point onward.

Inter vivos trusts

An individual may wish to use the Will to arrange testamentary trusts for heirs. A testamentary trust was taxed using the graduated tax rates, whereas *inter vivos* trusts (those created during the settlor's lifetime) are taxed at the top marginal tax rates. Commencing January 1, 2016, both *inter vivos* and testamentary trusts will be taxed at the top marginal rates, except for estates that qualify as graduated rate estates (GREs). Alter ego and joint partner trusts are considered *inter vivos* trusts. Once a trust is established as an *inter vivos* trust, it will remain so. It will not become a testamentary trust upon the death of the settlor, even if assets remain in the trust after the death of the settlor.

If the trustee continues to manage the assets for the heirs, they may make a designation that any income and/or capital gains that are taxable to the trust will be taxed at the top marginal tax rate. Commencing January 1, 2016, this designation can only be made if the trust's taxable income would be nil, meaning the designation can only be made in situations where the trust has loss carryforward amounts.

Other issues to consider

As with any aspect of estate planning, these trusts are not necessarily the best option for everyone. There are some issues to be kept in mind when considering using this strategy:

- The cost of setting up and running the trust (i.e., set-up fees, professional fees for legal and accounting advice and tax reporting) may not be worthwhile if your assets can be distributed efficiently through other estate-planning methods
- If you plan to include private company shares or qualified farm property in the trust, you need to keep in mind that the lifetime capital gains exemption is not available to the trust on a subsequent sale of the property
- Currently, charitable donations by Will or beneficiary designation may offset up to 100% of your terminal year net income, with any excess allowed to be carried back and used as a credit against your net income from the previous year. On the other hand, while a trust may also make donations, it is limited to a maximum credit of 75% of income earned in the year of death, and there is no carryback to the preceding year. Due to the new deeming provision effective January 1, 2016, any charitable donations made by the alter-ego or joint partner trust will no longer be available to offset this income triggered after the death of the settlor of an alter-ego trust or the last spouse of a joint partner trust
- Beginning January 1, 2016, alter ego trusts will have a deemed year end triggered by the death of the settlor. The trust income will be taxed in the deceased settlor's terminal return and not the trust's return. Essentially, the tax costs associated with the trust's accrued capital gains and investment income will become a liability of the deceased settlor's estate. In situations where the deceased's estate does not have sufficient assets to pay the associated tax liability, the Canada Revenue Agency deems the estate as the primary taxpayer and will only attempt to recover any unpaid taxes from the joint and several liable taxpayer (the trust) where the estate of the settlor is otherwise insolvent or unable to settle the liability
- Provided certain conditions are met, the estate of a deceased taxpayer may qualify as a GRE. A GRE will have access to the graduated tax rates for the first 36 months, be permitted to utilize the flexible donation charitable tax rules and access amongst other benefits specific to GREs. It's important to note that if a trust makes a loan or payment to the estate of the settlor to pay the taxes (as per the responsibility imposed under the joint and several liability), it could potentially disqualify the estate as a GRE and lose the many benefits accorded to these trusts

Effective and efficient

If you are looking for flexibility and control in planning your estate, alter ego and joint partner trusts could be what you need. Your advisor can help you explore different options for an effective and efficient estate plan.

For more information about this topic, contact your advisor, call us at 1.800.874.6275 or visit our website at www.invesco.ca.

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