TAB 9

Alter Ego and Joint Partner Trusts – EAT, Prey and Love?

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13th ***Annual*** **Estates and Trusts Summit**
Day One - November 17, 2010

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I. INTRODUCTION

This paper presents an overview of possible uses of alter ego and joint partner trusts as substitutes for wills and powers of attorney and in succession planning for those age 65 and older.

There are a number of real and perceived advantages to using a trust as a will and power of attorney substitute which will be explored in this paper. As well, several important tax and legal considerations must also be counter-balanced against the benefits of using a trust, which will also be identified. Each client situation is, of course, unique. The challenge is in the careful evaluation of those situations in which an alter ego trust or joint partner trust may be appropriate, which involves a sophisticated understanding of a host of applicable legal and tax considerations and a clear understanding of the client's objectives.

In order for these vehicles to have broader application, the professional and legislative response in Canada to their use as a viable alternative to a will and power of attorney requires a similar developmental path to that which has been experienced in the United States. There, within the estate planning and legal profession, an ongoing debate has existed for well over forty years launched by proponents of the "revocable trust" (sometimes called "living trust") who have

argued that the use of a trust as the primary vehicle to pass wealth on death and manage incapacity is preferable to a will, and advocates of the traditional will and power of attorney school of thought who have taken a contrary view.

This debate has served to identify the myths and realities, as well as the relative advantages and disadvantages of using a trust as a will substitute. A backdrop to this ongoing debate has been incremental legislative changes in the U.S. at both the state and federal levels to better integrate and harmonize the use of a trust as a will substitute, including extending to revocable trusts the tax and legal treatment afforded to wills, estates and trusts under wills and specialized legislation to address areas where inconsistencies and legal and tax problems could arise.

In the best of all worlds, in the Canadian context, the emergence of these planning vehicles from introduction of the legislation providing for alter ego and for joint spousal or common-law trusts (referred to herein as "joint partner trusts") in 2001 should have initiated a process to harmonize the rules governing the taxation of trusts used as will substitutes with the taxation of the deceased on death and testamentary trusts. Clearly, a comprehensive legislative initiative is necessary if the use of a trust as a will substitute is to be optimized. Instead, what has ensued is a plethora of anomalies and pitfalls to be avoided resulting from the *ad hoc*, fractionalized approach which has been taken. If alter ego and joint partner trusts are not as popular as they should be, part of the blame lies in

striving to fit these vehicles into the existing special tax regime which governs *inter vivos* trusts, as opposed to testamentary trusts, and maintaining the distinction between the trustee as owner of the property, as opposed to the settlor/deceased, which does not allow for the array of benefits available on death to a deceased person. The challenge will lie in working to accelerate a legislative response at both the federal and provincial levels in order that these trusts may be effectively utilized as a vehicle to control and dispose of property on death, which requires elimination of such distinctions.

The end product of this development will be another feather in the cap for the trust concept, which over the last several hundred years of common law development has an illustrious history of being resorted to as the preferred and most flexible tool for wealth succession and management. With our aging population, there is need for more seamless, cost-effective and sophisticated approaches to dealing with succession to property on death, as well as management of property on incapacity.

II. TRUSTS AS WILL SUBSTITUTES

(a) Introduction

Alter ego and joint partner trusts are often used as “will substitutes”, i.e. as an alternative to a will, or in combination with a will and other vehicles to dispose of property on death.

Most individuals control disposition of their property on death primarily by use of a will. If they do not do so, and do not have any other vehicle or instrument in place, provincial laws of intestacy and other statutory law will dictate distribution and administration of the estate.

Other common methods by which property is distributed on death include joint tenancies with right of survivorship and beneficiary designations under insurance policies, pension plans, annuities, registered retirement savings plans or similar plans.

One of the great perceived benefits of the use of a will is its "ambulatory" nature whereby it does not take effect until the death of the testator and can be changed at any time. In addition, if properly drawn, a will can comprehensively dispose of all of one's property on death and is generally prepared at a reasonable fee level.

With the high costs involved in probating a will in Ontario, however, over the last decade a greater interest in the use of a trust as a will substitute has evolved, together with a growing appreciation that many of the benefits provided by a will are also available by way of a well-drawn trust. As well, a trust offers many additional benefits as an estate planning vehicle, which in certain client situations makes it superior to a will, in particular in the elder client context.

(b) Avoidance of Probate

(i) Estate Administration Tax ("EAT") Minimization

Ontario EAT (formerly probate fees) essentially tripled in May of 1992. The first $50,000 of value of an estate is charged at the old rate of 1/2 of 1% and the value in excess of $50,000 at 1½%.

To circumvent the need for probate and attendant EAT, attention has been increasingly focused on methods of transferring property on death which do not require probate, including under a trust agreement.

While a will comes into force only upon death, a trust comes into immediate effect once fully constituted and can deal with disposition of property both during one's lifetime and upon death. Property held by the trust passes entirely outside of the estate and is distributed on death in accordance with the terms of the trust instrument. If properly structured, a trust can provide significant continued control and ownership to the party settling the trust.

The possible use of an alter ego or joint partner trust primarily for the purpose of minimization of EAT is a worthwhile planning consideration, particularly for elder clients. It may be particularly appropriate for those of very advanced years, where the anticipated administration costs of maintaining a trust and filing tax returns may not be as prohibitive because anticipated life span is shorter. It might also be appropriate if the tax planning opportunities otherwise arising on

death under current rules do not have application, (for example, if the plan of distribution does not involve the use of testamentary trusts for purposes of utilizing graduated tax rates available to testamentary trusts and other opportunities identified at a later point in this paper) or where the benefit of such rules might be achieved by using a partially-funded trust in tandem with a will and testamentary trusts.

(ii) Avoidance of Delay in the Probate Process

Another perceived benefit of avoiding the probate process by using an alter ego or joint partner trust as opposed to a will is that delays experienced in the probate process are thereby eliminated. The court process to admit a will to probate has become increasingly onerous under the rules to the *Estates Act* (Ontario). The requirement to serve all beneficiaries under a will with a copy of the will or an excerpt of their bequest or legacy before submitting an application to probate a will to court can result in additional delays if beneficiaries cannot be located. In addition, with increased government cutbacks there has been a general decline in the service level throughout the court system. Receipt of a Certificate of Appointment of Estate Trustee can sometimes take several weeks. At the same time that there has been a decline in service, there has been an increased burden placed on the applicant for a Certificate in terms of the preparation of court material and documents, which previously were prepared by court officials. These delays as well as the administrative burdens and costs involved in

preparing a court application are circumvented if an alter ego or joint partner trust is used as opposed to a will. On death, title to the assets of the deceased will already be in the name of the trustees. The death of the settlor of the trust can result in little or no impact on the ongoing administration of the trust.

(iii) Avoidance of Multiple Probate Proceedings

Another important application of the alter ego and joint partner trust as a will substitute is in respect of clients who have assets, in particular real estate, located in multiple jurisdictions. Under common law conflicts of laws rules governing succession to property on death, the law of the place where real estate is situate, i.e. the *lex situs* will generally control succession to such property on death. As a result, it is usually necessary to apply to admit a foreign will to probate in each jurisdiction where real estate is situate in order that the legal personal representative will have authority to deal with the assets in that jurisdiction. Needless to say, this process can be an extremely expensive, arduous and complicated one involving the need to liaise with local counsel and to interface with the foreign court process to deal with the assets in the foreign jurisdiction.

If title to real estate is held in the name of trustees under an alter ego or joint partner trust, on death of the settlor, there is no need to submit a will to probate in the foreign jurisdiction because the property will not form part of the settlor's estate. As a result, the administration of real estate is expedited and with

potential significant savings, including saving the payment of local court and professional fees in order to secure probate in the foreign jurisdiction. In some jurisdictions, legal fees for securing probate are established by tariff based on the value of the assets for which probate is being secured, which can be expensive if the assets are of significant value. It should be noted, however, that most civil law jurisdictions do not recognize the trust and accordingly the use of a trust in such jurisdictions is generally not advisable.

(iv) Increased Flexibility in Choice of Trustees

Use of an alter ego or joint partner trust also provides additional flexibility in the choice of trustees, in particular for the client who has assets in multiple jurisdictions.

Under local court rules, special requirements often exist before a foreign personal representative can qualify to receive a grant of local probate, and in some jurisdictions foreign individuals are not eligible to act. There are often bonding requirements for foreign personal representatives. Securing a bond is sometimes impossible, depending on the financial worthiness of the applicant, and is also expensive since the cost of the bond is based on a percentage of the value of the assets of the estate for which probate is sought. As well, it is a time-consuming and lengthy process. In will planning, the choice of executors and trustees is often circumscribed because of the problems which might be encountered in attempting to have the testator's preferred choice of executors

and trustees qualify in a foreign jurisdiction. In Ontario, this issue arises with regard to executors not resident in Ontario, or another Canadian province or territory or a Commonwealth jurisdiction. Most commonly, the issue arises with regard to trying to qualify a U.S. resident executor. Such constraints do not apply if a trust is used because there will be no need to interface with the local court process on death of the deceased.

(v) Simplification of Estate Administration

The use of an alter ego or joint partner trust to dispose of property on death may also result in significant simplification of the administration of assets on death.

To the extent that the deceased's assets have been transferred during the deceased's lifetime to a trust, the marshalling of assets and transfer of title to personal representatives, which normally forms a significant part of the estate administration process, has already been accomplished, and likely is more easily and expeditiously achieved during one's lifetime as owner than can ever be accomplished by one's personal representative after death. Personal representatives must establish their authority to deal with estate assets and must satisfy the unique compliance requirements of each financial institution or transfer authority to effect transfer of property from a deceased person. These compliance requirements are often not well understood or applied by financial institution personnel. The process of establishing authority by the personal

representative in order to deal with the deceased's assets and to effect a transfer of title is often fraught with significant paperwork, delay and expense.

Establishment of a trust may also force one to "put one's house in order" prior to death, and to create and organize a comprehensive record of all assets for purposes of effecting transfer to the trustees of the trust, thereby minimizing the risk of lost assets and incomplete information. This re-organization of assets significantly curtails the often laborious and frustrating process experienced by family members and third parties and professional advisors, often with no background or ties to the deceased or familiarity with his or her financial affairs, of attempting to reconstruct a person's affairs after they have died.

(c) Confidentiality

Another feature of the use of a trust as a will substitute is that the trust agreement is, and remains, a private document. This is in distinct contrast to a will submitted to probate. Many individuals do not appreciate that in order to secure a Certificate of Appointment of Estate Trustee, their will must be submitted to court, and that once the Certificate is issued, the will becomes a public document, available from the court file to anyone who wishes to secure a copy. In addition, all of the court documents submitted in support of the application for a Certificate are also available for public scrutiny.

Although in Ontario an application to appoint an estate trustee does not require a sworn inventory listing the estate assets and their values, it is still necessary to

include a value at death for any real property situate in Ontario and a value for personalty owned by the deceased. Other jurisdictions, including several Canadian provinces, require a detailed listing of all assets and their values as part of their probate proceedings. For those clients to whom confidentiality is a priority, the use of an alter ego or joint partner trust to dispose of property on death may be the motivating reason in itself for using a trust as an alternative to a will.

(d) Protection Against Estate Litigation

(i) Will Contests

The use of a trust to dispose of assets on death may also serve to decrease the potential for legal challenges to the deceased's dispositive scheme as reflected in the terms of a trust than if a will is used. There are a number of reasons why this may be so.

The first is that a trust provides for continuity in the holding of title to assets and their management on death. The trustees are already appointed, and the trust property is vested in them and under their control. They are in position to proceed with distribution of the assets, subject to payment of taxes and other debts and expenses of the trust and to carry out its terms. There is no change in control on death which occurs when estate trustees are appointed under a will who must first establish their authority to third parties to deal with the assets of the estate by submitting the will to court and obtaining probate.

It is the disjunctive period after death and prior to obtaining probate that often invites challenges to a will and creates a situation whereby, if only for sheer nuisance purposes, the administration of the estate can be held up, thereby giving parties who are dissatisfied with the terms of the will or who are otherwise litigation-motivated increased negotiating power and leverage. These problems are arguably minimized by use of a trust.

In addition, delays experienced in applying for probate, sometimes in more than one jurisdiction, can contribute to creating an environment where relationships become increasingly disharmonious, heightening the possibility for litigation.

There are also fewer formalities such as execution requirements required to establish a trust than to ensure a valid will, which will also tend to lessen challenges made on the basis of lack of formal validity.

As well, to the extent that a trust has been in existence for many years prior to death and under the settlor's and co-trustees scrutiny during such time, it would also seem that the type of challenges often made to a will based on lack of testamentary capacity, undue influence and suspicious circumstances, may be more difficult to sustain from an evidentiary viewpoint, particularly in respect of long-standing trust arrangements.

Another distinction is that the legal burden of proof differs between proceedings to challenge a will and to challenge or set aside a trust. In a dispute concerning

the validity of a will, the onus rests on the estate trustees seeking to have the will submitted to probate to establish that the will is *prima facie* valid, including that it has been executed in accordance with the legal requirements for wills and that the testator had testamentary capacity. In a challenge to the validity of a trust, however, the entire burden of proof rests on the party seeking to challenge the validity of the trust.

Historically, the burden of proof placed on estate trustees has resulted in spurious estate litigation. It is only relatively recently that the courts have taken a more hardline approach to penalizing parties who engage in unfounded or nuisance challenges to wills by the award of costs against such parties. On balance, however, the fact remains that there is still more opportunity to challenge a will with little or no exposure to costs until it is established in the litigation process that there is no factual basis to the challenger's allegations concerning the validity of the will. This point often only occurs after the discovery process has been completed, and significant costs have already been incurred, largely payable out of the estate.

In summary, disposing of one's assets on death by use of an alter ego or joint partner trust creates a more "seamless web" as opposed to the hiatus engendered after death pending probate of a will which is accompanied by the change in control to a new group of individuals, the estate trustees, who must first establish their authority. For all of these reasons, an alter ego or joint

partner trust should be seriously considered where a client fears potential beneficiaries or others might be litigation-oriented, and that challenges may be made to his or her plans for disposition of assets on death.

(ii) Spousal Property Claims on Death

Can an alter ego or joint partner trust be used to minimize or defeat a surviving spouse's equalization claim under the *Family Law Act* (Ontario) (the "FLA")? Since the introduction of the FLA in 1986 creating a regime for equalization of marital property on death, significant professional thought and literature has been addressed to this issue. The FLA itself, in contrast to that of other jurisdictions, has no specific "anti-avoidance" provisions for prohibited intra-marriage transfers. As a result, the potential ambit for planning to minimize potential claims for equalization by the transfer of property during marriage, including by way of a trust, has been broader than if the legislature had seen fit to include such express provisions. It has been left to the courts to determine what is or is not inequitable or illegal on these issues.

An ongoing concern has always been that alienating assets, including transfers to a trust for the purpose of removing them from the calculation of net family property in order to minimize a surviving spouse's equalization claim, is a form of fraud on one's creditors, based on the view that the surviving spouse's claim to equalization is in the nature of a creditor's claim against the deceased spouse's estate. The Ontario Court of Appeal in *Stone* v. *Stone*, 39 E.T.R. (2d) 292, 55

O.R. (3d) 491 (C.A.) has provided guidance on this issue in holding that where a deceased secretly transferred assets immediately prior to his death for the primary purpose of defeating his spouse's equalization claim, the transfer was a fraudulent conveyance. The court held that spouses stand in relation to each other in a debtor-creditor relationship, and that in a proper case, resort can be had to the *Fraudulent Conveyances Act* (Ontario) (the "FCA"). The transfers were set aside and the assets ordered returned to the deceased's estate.

It now appears clear in the Ontario context that where the primary purpose of a transfer of property made shortly prior to death in contemplation of death is to defeat or minimize a claim for equalization on death, the transfer may be set aside. It has been suggested that in certain cases, however, a transfer of property to an alter ego trust or to a joint partner trust where the spouse is a trustee may not attract the application of the *Stone* decision and the FCA because the spouse has not depleted his or her net family property given that the definition of the spouse's property under subsection 4(1) of the FLA would include, *inter alia*, "property disposed of by a spouse but over which the spouse has, alone or in conjunction with another person, a power to revoke the disposition or a power to consume or dispose of the property". If the spouse retains control over the property as a trustee, this provision might apply resulting in the inclusion of the trust interest in net family property.[1] As well, clearly if the

[1] See Barry S. Corbin, "Estate Planning with Joint Partner Trusts & Alter Ego Trusts", Trusts, Trustees, Trusteeships II, Ontario Bar Association, September 24, 2007, p.15

spouse retains an express power to revoke the trust, which is common in an alter ego trust or joint partner trust, this provision would appear to apply.

(iii) Dependant's Relief Claims

In Ontario, broad claw-back provisions exist under s. 72 of the Succession Law Reform Act (the "SLRA") which allow a court to include the value of assets in respect of several *inter vivos* transactions made by a deceased before death in determining the amount of a claim for support under this legislation and to charge such assets as security for payment of a dependant's support order. Included under subsection 72(3) are transfers to a revocable trust. Accordingly, a transfer to an alter ego trust or a joint partner trust which includes the power for the settlor to revoke it would not appear to be a viable means for protecting or minimizing exposure to such claims. In addition, any such transfers might also be subject to an action to set it aside under the FCA, depending on the facts. Consideration should be given to what is the "estate" for purposes of subsection 72(1) of the SLRA in assessing a possible claim for dependant's support.

(iv) Creditor Claims

The issue arises of whether assets held by an alter ego or joint partner trust settled during the settlor's lifetime are protected against creditor claims arising after the settlor's death which otherwise would have been subject to such claims had they formed part of the deceased's estate.

It would seem that while the settlor is living, the settlor's interest in the trust would be subject to the claims of his or her creditors. If the settlor's interest terminates on death there would be no further claim if the original transfer to the trust was proper and not subject to being set aside, including on the basis of it being a fraudulent conveyance under the FCA.

The position of an unsecured creditor against the deceased's estate appears to be far different. Statutory protection is available to the deceased's trustee against personal liability from claims by unknown creditors when the trustee distributes estate assets to the beneficiaries if the trustee has advertised for creditors in accordance with Section 53 of the *Trustee Act* (Ontario). This does not stop creditors, however, from following the assets into the beneficiary's hands after distribution to the beneficiaries has been made, provided the assets can be traced, and then claiming directly against the beneficiaries.

As a result, it would seem that use of an alter ego or joint partner trust as a will substitute may provide better creditor protection on death. In the United States, a number of states have addressed this issue by legislation that specifically allows recourse by a deceased's creditors and/or the personal representatives of the deceased's estate against the trustees of the deceased's revocable trust in an effort to address creditor's rights on the death of a settlor of a fully-funded revocable trust.

(e) Costs

In considering the possible advantages of use of an alter ego or joint partner trust as a will substitute, the costs associated with the creation, funding, retitling of assets and continued management of the trust must be taken into account. In some respects, the client is "pre-administering" their estate and must have an appetite for paying the upfront costs. There is a reticence on the part of many clients to do so. The costs will vary depending upon the time period for which the trust will operate. There is a possibility of the need to pay trustee fees depending on who is chosen as trustee(s). There will also be set-up fees and professional fees for initial and ongoing legal and accounting advice which must be taken into account, as well as in some cases the cost of maintaining accounting records for the trust, and of course for filing annual tax returns. If the trust will be maintained for a shorter period, as will generally be the case in planning for very senior elder clients, costs will be less and use of such a trust becomes a particularly relevant planning opportunity.

(f) Estate Liquidity

Another benefit offered by use of an alter ego or joint partner trust is that the immediate need for liquid assets, which often occurs in the case of an estate governed by a will, does not arise when the settlor dies. During the time period pending probate, there may be few or no liquid assets available to provide for the support of a surviving spouse or other family members or to meet immediate

cash needs. This situation is all too often a commonplace one creating great difficulty, in particular for dependants of the deceased, which can be avoided if such a trust is used.

(g) Continuity of Management

Because the trust instrument does not need to be submitted to a formal probate proceeding, an alter ego or joint partner trust also provides for greater continuity in management and administration of the assets of a deceased person. In contrast, until a Certificate of Appointment of Estate Trustee is obtained, most assets are virtually frozen prior to the estate trustee being in a position to establish to third parties his or her authority to deal with the deceased's assets. Continuity and a smooth transition on death can be very advantageous, particularly for clients who own complicated assets, including an active business, where minimal disruption to the business will be critical.

(h) Conflicts of Law

Use of an alter ego or joint partner trust as opposed to a will in the case of assets located in multiple jurisdictions also promotes greater harmony in determining which law governs the construction, validity and the administration of the trust. A well-drawn trust agreement will typically contain express provisions selecting the governing law for such issues, removing any ambiguity.

Wills seldom contain clauses for determining the governing law, leaving the matter to be determined in accordance with conflict of law rules. These rules are somewhat arcane, particularly in the case of testamentary trusts, and also invite the problem that the laws of more than one jurisdiction may apply. In the case of real estate, the law of the place where the real estate is situate usually governs these issues. In the case of personalty, the law of the deceased's domicile will generally determine these issues.

(i) Capital Succession Planning

Where the client's objective includes ensuring capital succession of his or her property to children and others, an alter ego or joint partner trust is a useful vehicle. In second marriage scenarios, it can be a protective device to be implemented prior to cohabitation or marriage, including where there is concern of "overreaching". It is also a useful tool in dynastic multigenerational planning to ensure succession of family wealth to the next generation.

III. USE OF ALTER EGO AND JOINT PARTNER TRUSTS IN PLANNING FOR INCAPACITY

(a) Trusts vs. Powers of Attorney

It is likely that alter ego and joint partner trusts will be more frequently utilized in the future as a means to provide for management of assets in the event of incapacity. A trust offers several benefits in this regard which are superior to

commonplace documents such as a Continuing Power of Attorney for Property or application to the court for appointment of a guardian.

(i) Flexibility and Comprehensiveness

By use of an alter ego or joint partner trust, one may appoint individuals of one's choice to act in the event of incapacity who are subject to the terms of a comprehensive trust instrument providing for the trustees' specific duties and powers and tailored to meet individual circumstances. In contrast, powers of attorney are typically simple documents which do not contain sophisticated provisions dealing with such matters as the appointment and replacement of trustees, or detailed provisions providing a framework for the management of property, including, for example, business assets.

(ii) Accountability

Arguably, a higher standard of fiduciary obligation applies to a trustee of a trust than to an attorney acting under a power of attorney. Trust law is highly developed and offers a more comprehensive legal regime than that which applies to powers of attorney. In Ontario, the law governing powers of attorney is primarily statute-driven under the *Substitute Decisions Act*, and leaves a number of issues unresolved or open, in light of the relative newness of this legislation and the paucity of case law development on various matters.

(iii) Continuity of Management

While a trust survives death, a power of attorney or appointment of guardian does not. Uninterrupted management can continue after death of the settlor without interruption or the need to wait until the legal personal representatives of the estate are in a position to act and can establish their authority to third parties, usually by production of a Certificate of Appointment of Estate Trustee.

(iv) Protection Against Financial Incapacity

Use of an alter ego or joint partner trust arguably offers superior protection to the client against his or her own financial incapacity as opposed to a power of attorney. The property held under the trust arrangement can be managed by the trustees in the event of incapacity, and the client for whom the arrangement has been put in place will not be able to independently deal with his or her assets once his or her incapacity has been determined in accordance with provisions stipulated under the trust agreement. In situations of increasing failing capacity, or where the donor of a power becomes delusional, this issue becomes a highly sensitive and difficult one. Such a situation is problematic under a power of attorney because the donor's powers are coterminous with those of the attorney. There is no way, failing resort to the courts and the appointment of a guardian of property or the appointment of the Public Guardian and Trustee as statutory guardian, to legally terminate the donor's ability to continue acting. The attorney is essentially only the agent acting for his or her principal, the donor of the power.

Where a trust is used, subject to the terms of the trust agreement, the client will not be able to independently deal with the assets in the trust without the involvement and decision of his or her trustees.

(v) Protection Against Third Party Financial Abuse

By use of a properly drawn trust agreement, maximum enjoyment and control of one's assets can be maintained until the occurrence of a stipulated event, such as incapacity, at which time management and control can be continued by one's trustees.

In a situation where there is a potential for undue influence and "overreaching" by friends and relatives in relation to a client's assets, a trust arrangement is more protective for many of the reasons explained immediately above. Because the client will not have independent control of his or her assets, and requires the involvement of his or her trustees, a wall of protection is created. In contrast, under a power of attorney, the donor can act unilaterally. How "protective" the trust will be will depend on how its terms have been structured, including whether any power to remove the trustees or to revoke the trust arrangement exists in the hands of the client.

(b) Protection Against Government Intervention

A trust arrangement is a highly private arrangement. It would seem that use of an alter ego or joint partner trust will result in less involvement of the courts or

government regulatory bodies such as the Public Guardian and Trustee than if a power of attorney is used. A power of attorney will terminate if a court application is brought for appointment of a guardian. As a result, it cannot be relied on to secure the client's choice of who should manage his or her affairs since this issue may always become a subject for court determination. If a client's assets are settled on trust, they will not be subject to such intervention – instead, only assets held by the client under his or her control will be. An alter ego or joint partner trust can be more effective in ensuring continued private and confidential control and management of one's affairs without the intervention of outside regulatory government bodies or the courts.

(c) Avoidance of Multiple Incapacity Proceedings

While it can be extremely problematic if a client dies with assets, particularly real estate situate in several jurisdictions, it is likely even more problematic if he or she becomes mentally incapable owning assets in multiple jurisdictions.

Failing the existence of powers of attorney prepared in each jurisdiction in local form which survive incapacity, the prospect would then arise of having to commence court proceedings in each jurisdiction for a guardian, committee or equivalent legal representative to be appointed, an extremely expensive and time-consuming process. In addition, local rules may prescribe that only a resident of the jurisdiction may be appointed by the court.

The use of an alter ego or joint partner trust will circumvent the need for multiple powers of attorney, as well as the problem countered if local law does not allow for continuing or durable powers of attorney which survive a donor's incapacity.

(d) Summary

The use of an alter ego or joint partner trust for planning for incapacity should become increasingly popular in Ontario, as it is in the United States. In many respects, it would appear to be a superior vehicle by which to plan for incapacity and should, as a result, gain increasing favour as our legal culture becomes more dissatisfied with available methods and looks to other alternatives.

IV. TAX CONSIDERATIONS IN USING AN ALTER EGO OR JOINT PARTNER TRUST AS A WILL SUBSTITUTE

(a) Exception to the 21-Year Rule

Under s.104(4)(a) of the *Income Tax Act* (Canada) (the "ITA"), there is a deemed realization of the assets of an alter ego trust on the date of death of the settlor, and on the date of death of the survivor of the partners in the case of a joint partner trust, and every 21 years thereafter unless an election is made to trigger an earlier disposition. Accordingly, alter ego and joint partner trusts have different treatment than most *inter vivos* trusts which are subject to a deemed realization on their 21st anniversary date.

(b) Taxation on Death: Top Marginal Rates

While the deceased and testamentary trusts are subject to graduated rates of tax, *inter vivos* trusts are subject to the top marginal rate applicable to individuals.

On death of the deceased, had assets been held directly held by him or her, capital gains arising further to the deemed disposition on death of capital property and land inventory would be taxed at graduated rates of tax. If instead such assets have been transferred to an alter ego or joint partner trust, on disposition they will be subject to top marginal rates of tax, resulting in more tax than if directly held.

(c) Loss of Testamentary Trust Status

If part of the estate plan involves the use of multiple testamentary trusts for income-splitting purposes, for example, multiple trusts under the will for children and grandchildren to whom income is to be paid or payable, an alter ego or joint partner trust which provides for a plan of distribution on death establishing such trusts will not achieve these planning objectives because the property was settled *inter vivos*. Consideration may then be given to the relative advantages and disadvantages of each approach, as well as to whether a trust can be used in tandem with a will, under which testamentary trusts are provided for, and sufficient assets left at the estate level in order that this planning opportunity may be optimally utilized.

It had been suggested when alter ego and joint partner trusts were first introduced that if an *inter vivos* trust is used, a power of appointment could be given to the settlor to appoint the trust assets on his or her death exercisable by deed or under will. The power could be exercised to direct that the trust assets be held on continuing trusts, and if the view were taken that only on death do such trusts come into existence, it was arguable they would qualify as testamentary trusts. Alternatively, it had also been suggested that trust agreements could be executed but left unfunded during the settlor's lifetime, to be funded on death. The terms of the alter ego trust or joint partner trust could name the trusts as beneficiaries on the settlor's death, directing the property be paid to the trustees to be held subject to the terms of the pre-existing trust agreements.[2]

In Interpretation Bulletins 2000-007928 (November 2, 2001) and 2001-007537 (March 23,2001) CRA has taken the position that neither of these techniques are viable in order to enjoy testamentary trust status. CRA's view is that a person cannot transfer his or her property on or after his or her death except by a will or other testamentary instrument, therefore the transfer of property from an alter ego trust to a trust created after the death of the settlor is not a transfer of property by the settlor of the trust. As well, property transferred to a trust prior to the settlor's death does not belong to the settlor at the time of his or her death

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[2] See Howard M. Carr, "Taxation of Trusts", Death and Taxes II, Law Society of Upper Canada, June 14, 2000, p.25-26.

and therefore cannot be considered to be a contribution by the settlor as a consequence of the settlor's death to a trust created subsequent to the settlor's death. Accordingly, CRA takes the position that trusts created upon the death of the settlor pursuant to the provisions contained in an inter vivos trust are inter vivos trusts and do not qualify as testamentary trusts.

The special election permitting a trust to designate income which was paid or payable as not having been paid or payable for tax purposes under subparagraph 104(6)(b) and subsections 104(13.1) and 104(13.2) of the *Income Tax Act* should be considered since its utility may either not be available or compromised if not taken into account if a trust is used as a will substitute. Where the beneficiaries are all at high marginal tax rates, the ability to tax income in a testamentary trust at graduated rates presents a relevant income-splitting opportunity, particularly where there are continuing testamentary trusts. Again, a solution may be to ensure sufficient assets are retained at the estate level to utilize this planning opportunity, and the surplus settled on trust.

(d) Separate Year of Death Returns

In the year of death, as well as the basic final return, several separate returns may be filed in which deductions and credits can be claimed. An income splitting advantage arises because the taxable income in each return is taxed at marginal rates.

If an alter ego or joint partner trust is used as a will substitute, this opportunity will be lost unless there are also directly-held assets of the deceased at death which can take advantage of this opportunity and the trust has not been fully funded.

(e) Fiscal Year-End Planning

While all *inter vivos* trusts must have a year-end of December 31, testamentary trusts have more flexibility. Often the date before the anniversary date of the date of death of the deceased person is chosen. However, any date may be chosen provided the first year-end of the estate is no longer than one year from the date of death.

The ability to choose a year-end offers a number of tax planning opportunities which will not be available where an alter ego or joint partner trust is used as a will substitute. For example, where large lump sum amounts are received, choosing the year-end between the date of such receipts, if there is more than one, can result in a deferral. As well, for other reasons it might be advantageous to tie in the year-end with other relevant year-ends based on the deceased's assets, for example, any corporate or partnership interests.

(f) Filing Deadlines and Post-Mortem Planning

For all *inter vivos* trusts, a T3 Trust Tax Return is due on March 31, except in a leap year when the return is due on March 30.

The terminal T1 Tax Return is due on the later of April 30 of the year following death and six months after date of death. In the case of testamentary trusts, the T3 Return is due 90 days after the chosen year-end.

It would seem that if death occurs later in the year, such as in November or December, if an alter ego or joint partner trust is used as a will substitute, there will be an extremely short time in which to prepare and file the T3 Return, and pay the tax due, which might be substantial if there is a deemed realization of the trust assets on death. Raising the necessary cash in an orderly and advantageous way, including from an investment perspective, is more problematic than in the estate situation where a will is used where there is more leeway in terms of filing dates. Query the problem which may arise where complicated valuations must be obtained for business and real estate assets for purposes of computing the tax, which often take significant time to obtain, as one problem, among others, that may arise.

(g) Impact on Charitable Donation Tax Credit Planning

In the year of death, a charitable donation credit of 100% of net income is available for gifts made under a deceased person's will to a registered charity or other qualified donee. As well, if bequests on death are greater than the amount eligible under this limit, the excess may be carried back to the taxation year prior to death and applied against the tax payable for that year, but subject to the same limits.

The same treatment is not afforded to alter ego and joint partner trusts. It would seem that in the year of death, if an alter ego or joint partner trust is used, a deemed disposition of the trust's assets may result in significant income in the hands of the trustees. It will accordingly be important to plan for charitable gifts, and how they may be best effected and structured. It should be noted that whether or not a "gift' to a charity allows for a donation receipt at all will depend on the terms of the trust. In some cases, CRA has taken the position that a distribution from a trust to a charity is in satisfaction of the charity's income or capital interest which does not qualify for a donation receipt, as opposed to a gift. For a thorough consideration of charitable donations and related tax issues reference should be had to Ian Worland's article on these issues.[3] The trust is more limited in its use of charitable donation tax credits since the one-year carry-back will not be available, however the trust can carry forward for five years. As well, the trust is subject to a credit of 75% of income and capital gains as opposed to 100%. Given the short time period available to file a T3 Return, in cases where death occurs near calendar year-end, it may be problematic to physically pay out charitable bequests in such a short time frame and provide the appropriate receipts on filing.

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[3] Ian Worland, "Alter Ego and Joint Partner Trusts", Estates, Trusts & Pensions Journal, Vol. 27 [2008] pp.306 - 333.

(h) Amendment and Variation of the Trust

As discussed above, one of the major perceived benefits of a will is its ambulatory nature, i.e. that it can be changed at any time and only comes into effect on death. As a result, the client is free to change his or her will provisions as he or she sees fit, and because the ownership interests do not arise until the moment of death, there are no tax consequences to effecting such changes.

Use of an alter ego or joint partner trust is more problematic because on settlement of the trust, the ownership interests come immediately into effect. As a result, if at a future date the settlor wishes to make changes to the provisions of the trust, the issue will arise of whether such changes will result in a taxable event and a possible disposition giving rise to tax consequences. Although the legislation for alter-ego and joint partner trusts permits tax-free transfers into the trust, it does not address the tax consequences of an amendment or variation of the trust and whether these events give rise to a taxable disposition in respect of capital property or land inventory held by the trust.

(i) Capital Gains Exemption Available on Death

On death, a $750,000 capital gains exemption is available in respect of qualified small business corporation shares and qualified farm property. This exemption, which would otherwise apply if the property were owned directly by the deceased cannot be claimed by an *inter vivos* trust, although it is possible in certain instances to allocate gains out to a beneficiary who can then claim the

exemption in his or her return in respect of the gains. On death of the settlor or the survivor of the partners in the context of an alter ego trust or joint partner trust, however, the deemed realization on death of such property which gives rise to gains is taxable to the trust and cannot be allocated to a beneficiary under the provisions of the ITA. Accordingly, in respect of such property, consideration will need to be given to utilizing the exemption prior to transfer to an alter ego or joint partner trust.

(j) Land Transfer Tax ("LTT")

Another consideration in funding an alter ego or joint partner trust is whether Ontario LTT is exigible on transfer of real property or any interest therein to it. In general, transfers to a trust which are gifts are a change of beneficial ownership but if no consideration is paid, whether direct or indirect, and provided there are no encumbrances on the property, no LTT is exigible. A Supplemental Land Transfer Tax Affidavit typically sworn by the Trustees must be submitted to the Land Registry or Land Titles Office. Reference should be made to the Ontario Ministry of Revenue's *Guide to the Requirements to Evidence NIL Value of Consideration for Conveyances Involving Trusts*.

(k) Harmonized Sales Tax ("HST")

Consideration should also be given to whether HST applies on transfer of property to an alter ego or joint partner trust or distribution from it. Generally, HST should not be exigible if the transfer was for no consideration and was not

be done in the course of a commercial activity. A transfer of real estate is considered a commercial supply unless exempted. An exemption applies for used residential property. The rules in this area are complex and beyond the scope of this paper.

(l) Principal Residence Exemption

A common asset transferred to an alter ego or joint partner trust is a principal residence. While probate fee minimization may be accomplished by a variety of means for financial assets, such as using a holding company in conjunction with a primary will and a secondary will, the latter of which will govern assets which may not require probate such as private company shares, holding companies are typically not used to hold personal use properties because of the shareholder benefit rules under the ITA. The principal residence exemption is generally available to a personal trust, including an alter ego trust and a joint partner trust and can be claimed by the trust provided certain requirements are met under the ITA, including that the trust designates the property as a principal residence and the trust has a "specified beneficiary" who ordinarily inhabits the residence, or the specified beneficiary's spouse, common-law partner, former spouse or common-law partner or child of the specified beneficiary does so.[4]

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[4] For a detailed discussion of some of the problems and pitfalls involved in application of the principal residence exemption to an alter ego and joint partner trust see Ian Worland's article (*supra*).

(m) U.S. Estate Tax Mismatch Issues

Where a client has potential exposure to U.S. estate tax on his or her death, either because he or she is a U.S. person for U.S. estate tax purposes or if the trust holds U.S. situs assets, use of an alter ego trust or joint partner trust may not be appropriate. Under the Protocol to the Canada-U.S. Tax treaty, relief is given between the two jurisdictions with respect to payment of U.S. estate tax and Canadian capital gains tax on the same assets in order to avoid double taxation. If Canadian capital gains and as well U.S. estate tax is payable on the same assets, a credit is available in the amount of the U.S. estate tax which can be applied against the Canadian tax paid on the capital gains. However, a mismatch could occur if there is a personal trust which holds the assets. While the U.S. estate tax liability can occur at the client's personal level U.S. tax rules "look through" to him or her, including in the situation of a revocable trust, the Canadian capital gains liability occur at the trust level. A mismatch results with regard to the level at which tax is paid, which could result in double tax which otherwise might have been avoided if the assets were held personally. The rules are complex and cross-border tax advice is required in such situations.

V. LEGAL CONSIDERATIONS IN USING AN ALTER EGO OR JOINT PARTNER TRUST AS A WILL SUBSTITUTE

(a) Structuring the Trust used as a Will Substitute

(i) During the Settlor's Lifetime

If a transfer to the trust is to qualify for rollover treatment, and the trust is to qualify as an alter ego or joint partner trust, its terms must meet the requirements under the ITA. In this regard, the following conditions must be met:

- subsection 73(1.01) must apply in order that the transfer to the trust be a "qualifying transfer";
- the transferor (i.e. the settlor) and the trust must be resident in Canada, the latter without reference to any deeming provision in the Act.

As well, under subsection 73(1.02), the trust must have been created after 1999 and the settlor must have been age 65 or older at the time the trust is created.

Due regard must also be paid to the anti-avoidance provision in respect of the 21-year rule that the transfer to the trust is not part of a series of transactions or events that included a subsection 107(2) transfer to the individual and one of the main purposes of which was to avoid a disposition under the 21-year rule.

In order to qualify as an alter ego trust, the terms of subsection 248(1) and paragraph 104(4)(a) of the ITA also require that the settlor must be entitled to receive all of the income of the trust that arises before the settlor's death, and that no other person may, before his or her death, receive or obtain the use of any of the income or capital of the trust.

In order to qualify as a joint partner trust, the settlor and his or her spouse or common-law partner must, in combination with each other, be entitled to receive all of the income of the trust that arises before the later of the death of the individual and the spouse or common-law partner, and no other person may, before the later of those deaths, receive or obtain the use of any of the income or capital of the trust.

To ensure the above requirements are met requires careful review of the trust agreement, including the trustees' powers, to ensure that the income rights are correctly preserved and not in any way "tainted", similar to the issues that arise in constructing a qualifying post –1971 spouse trust.

If the trust is being used as a probate avoidance technique, the dispositive terms of the trust will usually attempt to maximize the settlor's control and beneficial enjoyment during his or her lifetime, an issue which will undoubtedly be of prime concern to clients.

To ensure maximum control and beneficial enjoyment, many clients will wish to ensure that as settlor, they have some or all of the following powers:

- A power to revoke the trust or to amend or modify it;
- A power to withdraw trust assets further to a direction to the trustee to do so;
- A power to direct the investment of the trust assets but with the power to delegate this power to the trustees;
- Powers allowing the settlor control over the trusteeship, including appointment and removal powers;
- Power to appoint the trust fund on the settlor's death or termination of the trust.

If the trust is also to be used for incapacity planning, it may in addition contain provisions for how the determination of incapacity will be made, and create tailored provisions to deal with the above issues. In addition, the trust agreement could provide for it to become irrevocable upon incapacity. Alternately, a Continuing Power of Attorney for Property could contain provisions that the attorney's powers are limited and do not include any power to revoke the trust. This may be the more flexible alternative and better addresses the situation of a

settlor regaining his or her capacity who may wish to have the power to revoke the trust to ensure maximum control.

It must be recognized that once a trust relationship is established, and if there is a plan of distribution on death under the trust, there are potential contingent beneficiaries who have rights, including to scrutinize the administration of the trust and the conduct of the trustees. The settlor is no longer the sole owner of the property and can no longer act as such. If the integrity of the trust relationship is to be maintained, due regard must be had to this underlying change in ownership. As well, additional consideration must be given to providing protection to the settlor and co-trustees who are acting during the settlor's lifetime. In this regard consideration should be given to the following:

1) broad investment powers;

2) private approval of the trust accounts without resort to the courts;

3) power in the settlor during his or her lifetime to approve trustee compensation;

4) broad release and indemnity provisions for the trustees during the settlor's lifetime.

(ii) After the Settlor's Death

It is critical to ensure that the trust is properly integrated with the client's will. Typically, even if the trust is fully funded, it will still be important to ensure the client has a will as well. The will can operate to dispose of any assets not transferred to the trust. Some of the issues which will need to be addressed include the following:

- if there is a deficiency in the estate, whether testamentary debts and expenses and tax liabilities can be paid out of the trust;
- if there is a deficiency in the estate, whether any bequests or legacies or hotchpot provisions under the will are to be satisfied out of the trust assets;
- if a claim is made by a surviving spouse against the estate for equalization, whether any benefits provided for the spouse under the trust should terminate.

(b) Funding the Trust

A number of possibilities exist with respect to funding the trust. Some clients may be reticent to fully fund the trust due to concerns with respect to control and management, particularly if there is need for a co-trustee, as further discussed below.

To properly operate as a probate avoidance vehicle, the assets must, however, have been transferred to the trustees prior to death. Consideration can be given to ensuring the client also has a Continuing Power of Attorney for Property which specifically empowers the attorney to fund the trust. Of course, this approach will only assist if the transfer process is completed prior to death.

As well, to operate as an incapacity planning vehicle, it will be necessary to fund the trust. The Continuing Power of Attorney for Property can also be used in such event to fund the trust.

Where the dispositive provisions under the will are different than those under the trust, however, careful consideration must be given to the situations in which the attorneys should be able to fund the trust to ensure the client's objectives are carried out, and his or her dispositive plan not thwarted.

(c) Execution Requirements

Where a trust is used as a will substitute, and the settlor retains such a significant degree of control over the trust arrangement, that in fact, the trustees may be seen to be agents, the issue arises that no immediate trust may have been created and that the purported *inter vivos* trust may be considered a testamentary disposition. The upshot is that unless the trust has been formally executed in accordance with requirements for the execution of wills, the testamentary disposition will fail on death of the settlor.

In determining whether the trust has immediate effect, *Waters' Law of Trusts in Canada*[5] provides some guidance on these issues, as follows:

> "The control issue (*supra,* chapter 3, Part III D) lies in the background, especially with "alter ego" trusts where the settlor retains full interest in his lifetime, and is also trustee. See chapter 12, Part II A, and chapter 13, Part II A 7, for "alter ego" trusts. The difficulty there, tax law aside, is whether the purported trust instrument creates instead an agency relationship between "settlor" and "trustee". See, *supra,* chapter 3 Part III. Interests are provided for on the settlor's death, and this means that the trust dispositive terms embrace another or others beyond the settlor himself. But is there a trust only on the settlor's death? In the U.S. the revocable *inter vivos* rules are to the effect that the trust arises on its creation. See *Uniform Trust Code, 2000,* Art. 6. In Canada in the absence of direct authority the better view appears to be that, if the settlor has standard trustee powers, and *bona fide* conducts himself as a trustee, the purported trust will be received as a trust."

It may be suggested that where co-trustees are appointed, on a practical basis, the demonstration that the property is held as trustees may more easily be demonstrated than by the sole settlor/trustee. In any event, a cautious approach, depending on the terms of the trust, is to execute the trust in accordance with the requirements for wills. Alternately, consideration could be given to contemplating possible failure by incorporating the terms of the trust by reference in the client's will or providing for a dispositive plan under the terms of the will.

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[5] Waters, Gillen, Smith, Waters' Law of Trusts in Canada, 3rd edition, (Toronto: Carswell, 2005) p. 211.

(d) Merger

An issue which is well-developed under U.S. trust law involves what is sometimes termed merger of interest. It is trite law that given the creation of a trust involves the separation of legal and beneficial ownership of property, if one person has the entire legal and beneficial interest in property, there is no trust.

Query the situation where a sole trustee, A, has the life interest, and on his death B takes in remainder. During A's lifetime, is there a merger of interest, such that a trust does not exist? In some U.S. states, including New York, this question has arisen in a number of cases, and trusts have been held to fail on such basis. Legislation in New York has remedied this situation by allowing for the prevention of merger if, under a trust, the settlor is sole trustee and sole income beneficiary, provided at least one other person has a beneficial interest in the trust. Other states have statutorily authorized the creation of what are sometimes called "self-settled" trusts without this restriction.

Canadian trust law on these matters is by no means as well-developed as the extensive case law that exists in the U.S. What can be said, however, is that the situation of a "self-settled" trust, or declaration of trust where the settlor holds the property as sole trustee, is more problematic than where there is a transfer to trustees. Older Canadian case law is ambiguous even on the issue of whether a trust is binding where it contains a power of revocation, although the modern

view would clearly accept there is no legal conceptual impediment to reserving a power of revocation.[6]

It would seem that where a person acts as his or her sole trustee, and also has a life interest in the income, as well as a power to revoke, and to draw on the capital as he or she sees fit, and if further complicated by the retention of a general power of appointment over the trust property, an argument can be made that a valid trust has not been established, and that there was no true intention to establish a trust, nor any real alienation of beneficial interest on others. The ambiguous state of the law in Canada on these issues leaves the matter unclear.

A transfer to trustees where the settlor acts with co-trustees obviates many of these issues. Another approach may be to create a vested interest in a portion of the trust property which cannot be defeated by the actions of the declarant/trustee.

Should the disposition plan on death under the trust differ from that under the estate, the issue of attacks on the trust on the basis that no trust existed becomes very germane in particular where a purpose of the trust was as a defense against such attacks. It is critical in particular in such instances to ensure that the trust cannot be attacked and set aside in order to claw-back assets from the trust into the estate.

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[6] For a discussion on these points see Waters', *supra*.

VI. CONCLUSION

This paper has surveyed various benefits of, and several opportunities for, using an alter ego or joint partner trust in estate planning.

Intrusive legislation governing powers of attorney, and the punitive level of Ontario Estate Administration Tax create a real incentive to the use of these types of trusts, which if properly drawn and in appropriate circumstances allow greater flexibility, tax and fee minimization and continued private management of one's affairs.

Reliance on the traditional "tried and true" but often simplistic will and power of attorney in planning for disposition of assets on death and incapacity do not fulfill many client's needs and consideration of the use of alter ego and joint partner trusts is a further option to be explored in comprehensive estate planning.