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TAB 4

Practice Gems: Administration of Estates 2020

Administration of an Estate where there is an Alter Ego Trust and Planning by an Attorney under a Continuing Power of Attorney for Property

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Part I – Administration of an Estate where there is an Alter Ego Trust

a. What is an Alter Ego Trust?

An Alter Ego Trust ("**AET**") is an effective tool to assist in probate and incapacity planning. An AET is an *inter vivos* trust set up during an individual's lifetime. An AET is for the exclusive benefit of one person during his or her lifetime, and to qualify as an AET under the *Income Tax Act* (Canada) (the "**ITA**")[1], the following conditions must be met:

1. the trust must have been created after 1999;
2. the settlor, at the time the trust is created, must be at least 65 years old and resident in Canada;
3. the settlor must be entitled to receive all of the income earned by the trust during his or her lifetime; and
4. only the settlor may receive any payments of income or capital from the trust prior to the settlor's death[2].

If all of the above requirements for an AET are met, the settlor can transfer capital property to the trust on a tax-deferred or rollover basis[3]. On transfer to an AET, the property is deemed disposed of at the individual's adjusted cost base ("**ACB**") and, subsequently, is deemed to be acquired by the AET at that same ACB. Capital property includes property such as stocks, bonds, mutual funds, personal-use property such as a principal residence, and private company shares[4].

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[1] R.S.C. 1985, c.1 (5th Supp.), as amended.

[2] *Ibid* at section 73.

[3] This rollover is only available to AETs and joint spousal or common-law partner trusts.

[4] *Supra* note 2. For the deferral of tax on the transfer of capital property to apply, both the individual and the transferee trust must be resident in Canada. Therefore, if the individual is a non-resident of Canada, the rollover rules will not apply.

There may be situations where the transfer of capital property on a rollover basis to an AET is not desirable. For example, if an individual wishes to utilize his or her capital gains deductions on certain property, section 73(1) of the ITA allows the individual to elect that the rollover rules will not apply[5]. Another situation where the transfer of capital property is not particularly desirable is with respect to Registered Retirement Savings Plans ("**RRSPs**") and Registered Retirement Income Funds ("**RRIFs**"); RRSPs and RRIFs cannot be transferred to an AET unless the assets are withdrawn first, which is normally not advisable, as tax will be payable on any amount withdrawn from an RRSP or RRIF in the year the withdrawal is made.

b. The 21-year deemed disposition rule

An AET is deemed to have disposed of its trust property at the end of the day on which the death of the settlor occurs and every 21 years thereafter[6]. Thus, the normal 21-year deemed disposition rule[7] does not apply to AETs during the life of the settlor.

An executor administering an estate with an AET should take note that if an AET is to carry on as an *inter vivos* trust after the settlor's death, the trust property will be subject to the 21-year deemed disposition rule thereafter. In this situation, given that the AET is an *inter vivos* trust, the resulting deemed disposition by the trust on the death of the settlor will result in the income or capital gains being taxed in the trust at the highest marginal rate of tax applicable to individuals[8].

Any gains will be taxed in the trust's tax return and not the personal terminal return of the settlor. As a result, careful planning is necessary when implementing an AET, as the tax payable at death may have been lower if the assets were taxed in the hands of the deceased individual immediately prior to death rather than the assets being disposed of by the trust, as the individual may have been subject to a lower rate of taxation.

c. AETs in estate administration

[5] AETs do not benefit from the lifetime capital gains exemption on the sale of qualifying Canadian-controlled private corporation ("**CCPC**") shares or for shares held in a CCPC, or a qualified farm or fishing property.
[6] *Supra* note 1 at subparagraph 104(4)(a)(iv).
[7] *Ibid* at subsection 104(4). *See* subparagraph 104(4)(a)(ii.1), whereby an AET can elect to have the 21-year deemed disposition rule apply.
[8] *Inter vivos* trusts are subject to the highest marginal tax rate pursuant to subsection 122(1) of the ITA.

i. Reduction of probate tax

Transferring assets to an AET can result in a reduction of probate tax payable by the estate. Probate is the process whereby an individual's Will is certified by a provincial court resulting in judicial approval of the authority of the executors named in a Will. In Ontario, this process is called obtaining a Certificate of Appointment of Estate Trustee with a Will (hereinafter referred to as a "**probate certificate**") and probate tax is usually payable as part of the process of obtaining a probate certificate. Assets transferred to an AET do not form part of the estate and, therefore, are not included in the calculation of probate tax, which, in Ontario, is currently $15 for each $1,000 on the value of the estate exceeding $50,000. This transfer can result in a reduction of overall costs of administering the estate, not only in terms of there being no probate payable on the assets in the AET, but also as a result of reduced legal fees and time required to administer the estate due to the fact that the trustees of an AET will not need to obtain a probate certificate to administer the assets in the AET, which can be a complicated and time consuming process.

ii. Privacy and confidentiality

The trust document which governs the administration of an AET is private and will not be subject to public scrutiny. As a result, the existence of an AET in an estate administration may increase privacy and confidentiality as the assets held in an AET do not form part of the estate and, as such, are not subject to probate. On the contrary, assets that fall under a Will do form part of the estate and may be subject to probate, which will result in the Will becoming a public document whereby anyone can access its contents. Therefore, if the assets which would typically require a probate certificate to be transferred are held in an AET, those assets will benefit from a certain degree of privacy and confidentiality which assets falling under the Will and forming part of the estate may not.

Starting January 1, 2021, however, new trust disclosure and reporting rules will require certain information regarding an AET will need to be disclosed to the government, including the name, address, date of birth and tax identification number of the settlor, trustees and beneficiaries of the trust.

iii. Asset protection

Assets held in an AET may benefit from asset protection. This is because by transferring assets to a trust, an individual is transferring ownership of the assets to the trustee, and, as a result, no longer owns the asset, potentially making it unavailable to creditors. An executor administering an estate with an AET may take comfort in the fact that any assets in the AET may benefit from some protection from creditors. However, an executor who is administering an estate with an AET should take caution, as creditors may be able to make a claim against an income and/or capital beneficiary interest in an AET, which may decrease the amount of asset protection available to the estate with respect to the assets held in the AET.

iv. Spousal rollover

Executors of an estate with an AET should be aware that, due to the fact that an AET is deemed to have disposed of all of its property on the date of death of the settlor, and the property does not belong to the settlor at the time of the settlor's death, no spousal rollover is available[9]. Although the deemed disposition of the property in the AET occurs on and as a consequence of the death of the settlor, the property in the AET is deemed to be disposed of pursuant to subsection 104(4)(a) of the ITA, and is not considered to be the property of the settlor[10].

v. Continuation of AET after settlor's death

There is no graduated rate of taxation available if the AET is to continue after the settlor's death. For example, if funds are to continue to be held in trust for a child or grandchild, the funds are deemed to be from an *inter vivos* trust, and, therefore, will be taxed in the trust at the top marginal rate of tax. This could provide a disadvantage in comparison to a scenario where the funds passed through the parent's or grandparent's estate, and the estate would benefit from up to three years of graduated tax rates.

vi. Charitable donations from an AET

There are certain limits on charitable donations that may be made from an AET. As mentioned previously, to meet the requirements of an AET under the ITA, the AET is prohibited from

[9] *Supra* note 1 at subsection 70(6).
[10] Subsection 70(5) of the ITA provides for the deemed disposition of capital property of a taxpayer when the taxpayer dies.

distributing any of its income or capital to anyone other than the settlor during the settlor's lifetime. Consequently, the settlor of an AET will not be able to use trust assets to achieve potential charitable objectives during his or her lifetime; however, he or she may opt to donate any income or capital received from the AET to charity.

A charity may be named as a beneficiary of an AET to receive the property in the AET upon the settlor's death, in which case the AET may be eligible to claim a donation tax credit after the settlor's death.

d. Additional considerations

i. Alternative to a Power of Attorney for Property

An AET may serve as a good alternative to a Power of Attorney for Property ("**POA**"), which is a written document by which one person (the "**grantor**") appoints another person (the "**attorney**") to act on the grantor's behalf with respect to the grantor's property or financial affairs in the event of incapacity on the part of the grantor. One situation where using an AET is superior to using a POA is where an individual has assets in multiple jurisdictions, as they may need multiple powers of attorney to meet the different legal requirements for those jurisdictions. If assets are managed by the trustee of an AET, foreign banks and financial institutions may be more likely to recognize the authority of the trustee to act on behalf of the AET. An AET may also be superior to a POA to prevent a situation where an individual is not yet incapable, but has diminished capacity, and makes decisions with respect to his or her property that he or she would not typically make.

ii. Control and flexibility

Once assets are transferred to an AET, as mentioned above, the trustee assumes ownership and control over the assets. An individual may be able to retain control of the assets in the AET if he or she is appointed as the sole trustee of the AET, however, this will result in decreased asset protection. It is also important to note that, once settled, it is more difficult to change the terms of a trust than it is to change the terms of a Will, and certain tax consequences may arise when changing the terms of a trust.

Part II – Planning by an Attorney under a Continuing Power of Attorney for Property

a. What is a POA?

The *Substitute Decisions Act, 1992*[11] (the "**SDA**") is the legislation that governs powers of attorney for property. As stated in Part I, a power of attorney for property is a written document by which the grantor appoints the attorney to act on the grantor's behalf with respect to the grantor's property or financial affairs. A continuing power of attorney for property becomes effective upon execution and remains so during any period of subsequent mental incapacity on the part of the grantor; however, the grantor must have capacity at the time the power of attorney is made, which means that they must have attained the age of majority and have the required mental capacity to understand the nature and effect of the power being granted. For a power of attorney to be valid, provincial legislation in Ontario requires that it be in writing, signed by the grantor, witnessed by two persons, and the grantor must have capacity.

b. Why is a Power of Attorney Needed?

The creation of a power of attorney to manage the grantor's financial affairs during any period of incapacity is a typical element of estate planning. The attorney is authorized to do on the grantor's behalf anything in respect of property that the grantor could do if capable, except make a Will[12]; this includes making decisions related to personal and real property, as well as the day-to-day management of finances and banking. Thus, the failure to obtain a power of attorney for property could greatly restrict the ability to deal with or manage an individual's property in the event of incapacity.

c. Estate Planning under a Power of Attorney

There are a number of court decisions related to an attorney's ability to engage in estate planning on behalf of the grantor after the grantor has become incapable. In particular, the courts are reluctant to permit an attorney to do any type of estate planning that potentially diminishes the value of the property that is available to the grantor during the lifetime of the grantor or constrains control of or right to use the property. At the very least, the courts take the position that any estate

[11] S.O. 1992, c. 32, as amended [SDA].
[12] *Ibid* at section 7(2).

planning undertaken by the attorney must be for the grantor's benefit and must be capable of being revoked by the grantor should he or she regain capacity. In addition, the eventual disposition of property upon the death of the grantor should remain undisturbed by any planning carried out by the attorney.

An attorney is a fiduciary, and, for that reason, the SDA requires that the attorney exercise his or her powers with honesty, integrity and good faith and for the incapable person's benefit. While it is well known that an attorney may not alter or make a Will[13] or undertake any other act that is testamentary in nature on behalf of the grantor, there are some estate planning strategies that fall short of an actual testamentary disposition or document that the attorney can engage in. These include the following:

i. Gifts

An attorney can make a gift of property to the person who would be entitled to it under the Will if the gift is authorized by the SDA[14], and the POA, and the attorney has reason to believe that the grantor, if capable, would make the gift. The SDA permits attorneys to make gifts and loans provided the grantor's remaining property is sufficient to satisfy the grantor's basic needs and there is reason to believe based on the intentions of the person expressed before becoming incapable, that he or she would make them if capable[15].

While attorneys are generally not authorized to make gifts to themselves, there are instances where the courts have allowed such gifts where there is evidence that the grantor would have made the gift, if capable. In *Laird v. Mulholland*[16], the grantor and the attorney were longtime friends and the grantor gave her attorney a gift of $10,000. Since the attorney was a fiduciary bound to act in the interest of the grantor, there was a presumption of undue influence and the attorney had to show that the grantor gave the gift on the basis of her own "full, free and informed thought." The Ontario court allowed the gift from the grantor to the attorney, as the attorney was able to show that the incapable person often made generous birthday and Christmas gifts to the attorney and his family.

[13] *See Richardson Estate (Re),* 2008 CANLII 63218 (ONSC) wherein the court held that the designation of a beneficiary under a life insurance policy is akin to a testamentary disposition.
[14] *Supra* note 12 at section 35.
[15] *Ibid* at section 37.
[16] (1998), 21 E.T.R. (2d) 204 (Ont. Gen. Div.).

On the contrary, in *Westfall v. Kovacec*[17], where the attorney sought authorization to use funds belonging to the grantor for himself, the court did not authorize the gift as there was no evidence that the grantor would have made the gift if competent. The attorney argued that the amount of the gift to himself was a relatively small amount, that he needed the money, and the grantor did not need it, and that he was likely to inherit it anyway. The court stated that the attorney's reasons for justifying the gift were no more justifiable than theft and refused to allow the gift; the court held that gifts or loans to friends or relatives are only permitted where there is reason to believe, based on intentions that the incapable person expressed before becoming incapable, that he would make the gift if capable.

The SDA prohibits an attorney from making charitable gifts on behalf of an incapable grantor, unless the following conditions are met: (1) the power of attorney authorized the making of charitable gifts or there is evidence that the grantor made similar gifts while capable; (2) the grantor will be left with sufficient property after the gift to make expenditures reasonable necessary for: (i) his or her support, education and care; (ii) the support, education and care of his or her dependants; and (iii) any other expenditures necessary to satisfy the grantor's legal obligations; (3) the total amount of charitable gifts made by the attorney does not exceed the lesser of: (i) 20% of the income of the grantor's property in the year in which the gifts are made[18]; and (ii) the maximum gift limit, if the grantor provided for one in the power of attorney; and (4) the grantor, while capable, did not express a wish that charitable gifts not be made[19].

The British Columbia Court of Appeal has held that gifts made to reduce the value of an estate and reduce U.S. estate tax are not permitted[20]. In *Re Bradley Estate*, a committee for the estate's plan to reduce taxes for an incapable person, who was a U.S. citizen and would be subject to U.S. estate tax on her death, was not approved. The proposed plan set out that a number of annual *inter vivos* gifts would be made to the incapable woman's husband, children and grandchildren up to certain limited permitted under U.S. legislation so as not to be subject to any tax. The court found that the distributions were not in the best interest of the incapable woman, as the proposed plan involved a sizable diminution of her assets over the course of years, and,

[17] (2001) O.J. NO. 2942 (S.C.J.).
[18] *Supra* note 12 at subsection 37(5). It is possible for the attorney to apply to the court for authorization to make a larger gift.
[19] *Ibid* at subsection 37(4).
[20] *Re Bradley Estate* (2000), 31 E.T.R. (2d) 16.

given that she was only sixty-five, it was not clear what she might require in the future. In addition, the court found that the proposed gifting scheme was a significant departure from the distribution that would occur on an intestacy and, therefore, did not approve the plan.

ii. Beneficiary Designations

In general, the act of designating a beneficiary in respect of life insurance policies, pensions, Registered Retirement Savings Plans ("**RRSP**"), Registered Retirement Income Funds and Tax-Free Savings Accounts is considered a testamentary disposition and, thus, cannot be completed by an attorney on behalf of an incapable grantor[21]. The decision of the court in *Desharnais v. Toronto Dominion Bank*[22] exemplifies how the courts determine what constitutes a "testamentary disposition." In that case, the court concluded that the making of a beneficiary designation in respect of an RRSP is a testamentary disposition because, in the absence of statutory authority to designate a beneficiary, such an act would be contingent upon the death for its vigour and effect and, thus, is testamentary in nature.

iii. Estate Freezes

An attorney may effect an estate freeze on the part of the grantor where it would not reduce the value of the grantor's estate during his or her lifetime. In *O'Hagan v. O'Hagan*[23], an attorney was permitted by the court to undertake a freeze structured through a trust where the grantor was to be sole beneficiary of the trust during his lifetime and the plan did not deviate from what was contemplated in the grantor's Will. The court permitted the freeze notwithstanding the fact that it was not necessary for the benefit of the grantor on the basis that there would be no reduction in the value of the grantor's assets during his lifetime and that a freeze would result in a benefit to the grantor and his family. The court emphasized, however, that in making such a decision, the grantor's interests, present and future, must be given paramount importance.

iv. Inter *Vivos* Trusts including AETs

[21] *Supra* note 12 at subsection 7(2).
[22] (2001), 42 E.T.R. (3d) 192.
[23] (2000), 31 E.T.R. (2d) 3.

Attorneys can create *inter vivos* trusts that take immediate effect on behalf of an incapable grantor, provided that certain conditions are met. The court in *Banton v. Banton*[24] held that in creating an irrevocable *inter vivos* trust on behalf of an incapable grantor, the attorney has fiduciary obligations owing to the grantor which must be adhered to. In this case, the trust provided for income and capital at the trustee's discretion for the grantor's benefit during his lifetime and a gift over of capital to the grantor's children, who were also the attorneys. While the scheme of distribution from the trust was the same as provided for in the grantor's Will, the grantor married after the trust was settled, revoking the Will. The court found that the fact that the remainder interest in the trust were being gifted to the grantor's issue instead of being payable to the grantor's personal representatives on his death, did not interfere with the grantor's property to the least extent possible. Therefore, the court held that the attorneys had breached their fiduciary obligations owing to the grantor by transferring his assets to an *inter vivos* trust for their eventual benefit.

In a more recent case, *Easingwood v. Cockroft*[25], the court upheld an AET created by joint attorneys, a brother and a sister, to settle their incapacitated father's estate before his death. The grantor's son was dying and, under the POA, neither sibling could act as the sole attorney. As a result of this, on the brother's death, the POA would have become ineffective. Thus, the trust was created to allow a successor trustee to be appointed. In addition, there was the benefit that the estate would not be subject to probate. Some of the key factors the court considered in upholding the trust included the fact that the distribution provisions in the Will and the trust were basically the same, there was no conflict of interest between the grantor and the attorneys, and the trust was created for sound reasons.

In accordance with the foregoing rationales, a court would likely uphold the act of a grantor settling an AET on behalf of an incapable grantor if the terms of the AET are consistent with the grantor's Will, as the AET is for the sole benefit of the grantor during his or her lifetime. If the settling or variation of an existing *inter vivos* trust, including an AET, would have the effect of changing the manner in which the capital of the trust was to be distributed on the grantor's death, such a settlement or variation would be considered to be testamentary in nature, and, therefore, unable to be decided by an attorney[26].

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[24] (1998), 164 D.L.R. (4th) 176.
[25] 2013 BCCA 182.
[26] *Bank of Nova Scotia Trust Co. v. Lawson* (2005), 22 E.T.R. (3d) 198, 25 CarswellOnt 7263.