TODAY'S TRUSTS FOR ESTATE PLANNING

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There are a variety of options available to individuals who are interested in using trusts as part of their estate plan. This paper discusses some of the benefits and issues arising from the use of testamentary trusts and *inter vivos* trusts.

The paper will first provide a general overview of select tax issues that apply to trusts in estate planning situations. It will then address the personal and tax considerations with regard to the following specific uses of trusts in estate planning:

a) certain uses of testamentary trusts, including income splitting;
b) life insurance trusts;
c) certain uses of *inter vivos* trusts including, sheltering capital gains and trusts in an estate freeze; and
d) *alter ego* and joint partner trusts.

1. Trusts — General

A trust is a relationship between the trustees of the trust, who hold legal title to the trust property, and the beneficiaries. A trust is not created until the three certainties have been satisfied: the intention to create the trust relationship (certainty of intention); the identification of the beneficiaries or class of beneficiaries (certainty of objects); and the identification of the property that will settle the trust (certainty of subject matter). Once a trust exists, there are certain tax rules that are applicable.

A trust is not a separate legal entity. It is a relationship between the trustees and the beneficiaries. For tax purposes, the *Income Tax Act* (Canada)[1] provides that a reference to a trust or estate will be read to include a reference to the trustee, executor, or other legal representative

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1. R.S.C. 1985, c. 1 (5th Supp.) as amended (the "ITA").

having legal ownership of the trust property.[2] It further provides that for the purposes of the ITA a trust will be deemed to be an individual.[3] Thus, for tax purposes generally a trust or estate is treated as an individual taxpayer. However, where income (including taxable capital gains) is paid or payable to a beneficiary of the trust, the trust acts as a conduit and the beneficiary is taxed.[4] The trust is entitled to a deduction in computing its income.[5]

The following discussion provides an overview of certain key provisions in the ITA applicable to trusts that are frequently a consideration in estate planning. Please note that there may be different considerations regarding the tax treatment of trusts depending on whether a trust is testamentary or *inter vivos*.

(1) 21-Year Deemed Disposition Rule

Under s. 104(4) of the ITA, a trust is deemed to have disposed of all its capital and depreciable property at its fair market value on the twenty-first (21st) anniversary of the settlement of the trust and to have reacquired it at the same fair market value. The effect of this provision is to trigger the notional realization of accrued but unrealized capital gains and to subject the deemed taxable gains to tax.

The deemed disposition rule can be avoided by distributing the trust's property to the capital beneficiaries prior to the 21st anniversary of the trust's establishment. In general, a distribution of a trust's property to the capital beneficiaries can be done on a rollover basis.[6]

(2) Attribution Rules

Under the ITA, there are various attribution rules related to trusts that must be considered when undertaking any estate planning. The attribution rules apply to attribute income back to the transferor of property in certain situations.

Pursuant to s. 74.1(2) of the ITA, where property has been transferred or loaned to a trust for the benefit of a person who was under age 18 and who was not dealing at arm's length[7] with the transferor, or was the niece or nephew of the transferor, the income from the transferred property held by the minor is deemed to be that of the

2. ITA, s. 104(1).
3. ITA, s. 104(2).
4. ITA, s. 104(6) and (13).
5. ITA, s. 104(6).
6. ITA, s. 107(2).
7. ITA, s. 251(1).

transferor and not that of the minor. This attribution rule will not apply to transferred or loaned property where:

(i) there is no income from the transferred property (*e.g.*, where the property transferred is a silver coin);

(ii) the income is accumulated and taxed in the trust and is not paid to the minor while under age 18;

(iii) the lesser of the "prescribed rate"[8] or commercial rate of interest is charged in respect of the loan and the interest is actually paid within 30 days of the end of the particular year;[9]

(iv) the minor who received the property or who is the beneficiary of the recipient trust attains age 18 before the end of the particular year;[10] or

(v) the transferor is a non-resident.[11]

Under ss 74.1(1) and 74.2(1) of the ITA, where property has been loaned or transferred to a trust for the benefit of the transferor's spouse or common law partner, the income and capital gains, respectively, from that property are deemed to be that of the transferor and not the transferee spouse.

The ITA also deals with income splitting through the use of trusts and corporations.[12] Under s. 74.4 of the ITA, when an individual has transferred or loaned property either directly or by means of a trust to a corporation and one of the primary purposes of the transfer or loan is to benefit a spouse, common law partner, minor who is not at arm's length with the individual, or niece or nephew of the individual, interest on the property at the prescribed rate[13] may be required to be included in the transferor's income. Most trust agreements contain a provision which prevents distributions to minors in the event that the corporate attribution rule could apply.

Attribution may also apply under the ITA where there has been a revocable transfer of property to a trust. Section 75(2) of the ITA provides that any income or loss or taxable capital gain or allowable capital loss on certain property will be attributed back to the transferor. Its application is triggered (i) where property (or substituted property) may revert to the transferor of the property or pass to persons to be determined by the transferor at a future time, or (ii)

8. *Income Tax Regulations*, C.R.C. 1978, c. 945, s. 4301(c).
9. ITA, s. 74.5(2).
10. ITA, s. 74.1(2).
11. *Ibid.*
12. ITA, s. 74.4.
13. *Supra,* footnote 8.

where the property (or substituted property) may not be disposed of without the transferor's consent.

Section 75(2) is a particularly problematic rule as it has consequences additional to the attribution of income and capital gains/losses back to the transferor. Specifically, if s. 75(2) applies, then the rollout of trust capital under s. 107(2) is denied and such a distribution will be a taxable event under s. 107(2.1) of the ITA.[14]

2. Testamentary Trusts

A testamentary trust is defined in the ITA as a trust or estate[15] that arises on and as a consequence of the death of an individual, other than:

(*a*) a trust created by a person other than the individual,

(*b*) a trust created after November 12, 1981 if, before the end of the taxation year, property had been contributed to the trust otherwise than by an individual on or after the individual's death and as a consequence thereof, and

(*c*) a trust created before November 13, 1981 if

- (i) after June 28, 1982 property has been contributed to the trust otherwise than by an individual on or after the individual's death and as a consequence thereof, or
- (ii) before the end of the taxation year, the total fair market value of the property owned by the trust that was contributed to the trust otherwise than by an individual on or after the individual's death and as a consequence thereof and the property owned by the trust that was substituted for such property exceeds the total fair market value of the property owned by the trust that was contributed by an individual on or after the individual's death and as a consequence thereof and the property owned by the trust that was substituted for such property, and for the purposes of this subparagraph the fair market value of any property shall be determined as at the time it was acquired by the trust.[16]

These exceptions provide that a trust cannot be a testamentary trust if the trust is created by anyone other than the testator or if property is contributed to the trust by anyone other than the testator. If a trust is not a testamentary trust, it is an *inter vivos* trust.[17]

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14. ITA, s. 107(4.1).
15. Section 99(1) of the July 18, 2005 draft legislation will delete the word "estate" in the definition of "testamentary trust" in s. 108(1) because s. 104(1) provides that references to a "trust" in ss. 104 to 108 include a trust or estate.
16. ITA, s. 108(1) "testamentary trust".
17. ITA, s. 108(1) "inter vivos trust".

Testamentary trusts may be used as an important component of an effective estate plan, as they can serve many purposes and they offer a variety of tax and other benefits. Testamentary trusts can be used, among other things:

- to provide for life interests. For example, a testator can provide in his or her Will that his or her spouse from a second marriage will have a life interest in certain property, as opposed to an outright gift, in order to preserve that property for his or her children. Alternatively, a testator may wish to provide a life interest to his or her children in order to preserve the capital for a future generation;
- to prevent beneficiaries from using legacies improperly. Transferring property to a trust upon death as opposed to the beneficiary outright allows the testator to choose a trustee who will administer the property for the benefit of the beneficiary subject to any trust terms provided by the testator. The testator can structure the testamentary trust in his or her Will to provide for staggered distributions of capital when a beneficiary attains a certain age. In addition, the trust can give the trustees discretion with regard to distributions of income and capital allowing the trustees to take into consideration future personal and financial circumstances of the beneficiaries;
- to provide income and capital to disabled beneficiaries through a Henson trust.[18] A Henson trust is one which gives the trustees absolute discretion in making distributions of income and capital to the disabled beneficiary;[19] and
- to split the income of beneficiaries in high tax brackets. The income-splitting opportunity has recently resulted in proposed amendments to the ITA, which are discussed in more detail below.

Recent Draft Legislation Regarding Income Splitting

A testamentary trust is taxed at the same marginal rates as individuals;[20] an *inter vivos* trust, on the other hand, is taxed at the top marginal rate.[21] As

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18. Based on the decision in *Ontario (Minister of Community & Social Services) v. Henson* (1987), 28 E.T.R. 121, 26 O.A.C. 332 (Div. Ct.), affd 36 E.T.R. 192 (Ont. C.A.).
19. According to provisions of the *Ontario Disability Support Program Act, 1997*, S.O. 1997, c. 25, Sch. B, a disabled person is entitled to benefits if he or she does not have liquid assets exceeding $5,000. Under the regulations, recipients of benefits can receive up to $4,000 per year from a Henson trust and the trust can pay disability related expenses without the beneficiary suffering a decrease in benefit payments.
20. ITA, ss. 117(2) and 104(2).
21. ITA, s. 122(1).

testamentary trusts are taxed at the marginal rates, there is the opportunity to split income by using testamentary trusts.

A testator may wish to create multiple testamentary trusts to take advantage of this tax planning opportunity. That is, if a testator has four children whom he or she wishes to benefit, he or she may create four separate trusts, one for each child under his or her Will. Each of these testamentary trusts will be a separate taxpayer for tax purposes and subject to the marginal tax rates.

Section 104(2) of the ITA prevents the creation of multiple testamentary trusts with the same beneficiary. Section 104(2) provides that when there are multiple trusts and substantially all of the property in such trusts has been received from one person, and the trusts provide that the income accrues to the same beneficiary or beneficiaries, for the purposes of the ITA the Minister may designate that such trusts be treated as one trust.

Canada Revenue Agency ("CRA") has taken the position that generally s. 104(2) of the ITA will not apply where a testator creates a separate trust for each of his or her children. CRA indicated that it will consider several factors in determining whether s. 104(2) is applicable, including:

- whether or not there was a clear intent by the testator as evidenced by the terms of the Will, to create separate trusts;
- whether or not the trusts had common beneficiaries;
- whether or not the assets of each trust were segregated and accounted for separately (*e.g.*, separate bank accounts, no undivided interests in property, separate accounting records for income received and capital and/or income disbursements); and
- the conduct and powers of the trustees.[22]

Thus, when structuring multiple testamentary trusts in a Will, or advising trustees of such multiple testamentary trusts, it is important to be aware of and comply with CRA's position in order to avoid the application of s. 104(2).

Because of concerns of income-splitting with testamentary trusts, the Ministry of Finance introduced draft legislation on December 20, 2002, which was subsequently revised on July 18, 2005 (the "Draft Legislation"). Under s. 99(2) of the Draft Legislation, the following para. (d) will be added to the definition of "testamentary trusts" in s. 108(1), applicable to trust taxation years that end after December 20, 2002:

> (d) a trust that, at any time after December 20, 2002 and before the end of the taxation year, incurs a debt or any other obligation owed to, or

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22. CRA Technical Interpretation 9812985, "Testamentary Trusts", January 14, 1999.

guaranteed by, a beneficiary or any other person or partnership (which beneficiary, person or partnership is referred to in this paragraph as the "specified party") with whom any beneficiary of the trust does not deal at arm's length, other than a debt or other obligation

(i) incurred by the trust in satisfaction of the specified party's right as a beneficiary under the trust

(A) to enforce payment of an amount of the trust's income or capital gains payable before that time by the trust to the specified party, or

(B) to otherwise receive any part of the capital of the trust,

(ii) owed to the specified party, if the debt or other obligation arose because of a service (for greater certainty, not including any transfer or loan of property) rendered by the specified party to, for or on behalf of the trust, or

(iii) owed to the specified party, if

(A) the debt or other obligation arose because of a payment made by the specified party for or on behalf of the trust,

(B) in exchange for the payment the trust transfers a property to the specified party within 12 months after the payment was made (or, where written application has been made to the Minister by the trust within that 12 months, within any longer period that the Minister considers reasonable in the circumstances), and

(C) it is reasonable to conclude that the specified party would have been willing to make the payment if the specified party dealt at arm's length with the trust.

The effect of this proposed provision is that a trust that has received a loan from a beneficiary or from someone with whom the beneficiary does not deal at arm's length (a "specified party"), will not be a testamentary trust unless: (a) the trust incurs the debt in satisfaction of the specified party's right to enforce payment of income or capital gains or to receive any part of the capital of the trust; (b) the debt arose because the specified party rendered services to the trust, such as services rendered in the capacity of trustee of the trust; or (c) the debt arose because the specified party made payments on behalf of the trust, if the trust reimburses the specified party by transferring property to the specified party within a year of the payment.[23]

The last condition (C) can be reasonably interpreted to mean that the specified party needs to charge a commercial rate of interest to the trust or be otherwise compensated for the payment made by the

23. The twelve-month period can be extended upon application to the Minister of National Revenue.

specified party. The Tax Policy Branch of the Department of Finance issued a letter on April 28, 2004 (the "Comfort Letter") in response to the concern of a taxpayer that in the case of the vast majority of estates of deceased individuals, the specified party, often a family member of the deceased, will undertake to make payments on behalf of the estate, without any expectation that the repayment by the estate will include an arm's length amount of interest. In such circumstances, the result would be the loss of testamentary trust status. Since the policy objective of the proposed para. (d) is to prevent property from being transferred to testamentary trusts in order to take advantage of the marginal rate of taxation, losing the testamentary trust status for loans for payments of funeral expenses, for example, is not consistent with the goals of the Draft Legislation. In the Comfort Letter, the Department of Finance stated that:

> . . . the loss of an estate's status as a testamentary trust, in these circumstances, would be inconsistent with the policy objectives of proposed paragraph (d) of the definition. Therefore, we are prepared to recommend a modification . . . to provide that the requirement in clause (C) . . . not apply where the payment for or on behalf of an estate is made within the first 12 months after the individual's death . . . As a result, where the remaining conditions . . . are satisfied, to the extent that the circumstances do not involve an attempt to use the estate as a vehicle for income splitting, the anti-avoidance provisions of the [ITA] would not be expected to apply to cause the estate to lose its status as a testamentary trust.

To ensure that testamentary trusts do not lose their status and become *inter vivos* trusts, estate trustees must ensure that the twelve-month period for advances and repayments are observed, unless permission for an extension has been obtained from the Ministry of Finance.

Because of the tax advantages of having a testamentary trust in place, it is important to ensure that there is nothing done to a testamentary trust to taint its status as such. If a testamentary trust loses its status as a testamentary trust, it will be taxed as an *inter vivos* trust and therefore subject to the highest marginal tax rate. In order to avoid tainting a testamentary trust, the following should be observed:

- As indicated above, where any advances are made to the trust, the trustees must ensure that such advances and repayments are made within the 12 months following the testator's death.
- Property must not be contributed to the trust by a living person at any time.
- No living person, including a beneficiary, may pay capital expenses of the trust, as CRA considers the payment of such

expenses to be a contribution to the testamentary trust which would taint the status of same.[24]

- Caution must be taken if the beneficiaries seek to vary a testamentary trust. In this regard, CRA has indicated that where a trust is varied by an agreement among the beneficiaries, this may result in the creation of a new trust.[25] Where a new trust is created, this would be an *inter vivos* trust.

3. Life Insurance Trusts

Life insurance may be used as another integral part of an effective estate plan. In some cases, a testator may wish to structure his or her estate plan such that any life insurance proceeds are not paid directly to a beneficiary or beneficiaries. (There may be many reasons for doing this, similar to those discussed above regarding testamentary trusts). The testator may designate the estate as his or her beneficiary of the life insurance proceeds and can then provide for testamentary trusts in his or her Will. Alternatively, it may be advantageous for a testator to establish a life insurance trust, particularly if the beneficiary of the life insurance proceeds would otherwise be the estate and therefore be subject to probate fees and claims from creditors of the deceased.

A life insurance trust can be established through either a trust deed or a Will. If the life insurance trust is established through a Will, the Will designates the trustees to whom the proceeds of the life insurance policy would be paid and for whom the proceeds would be held in trust. If the life insurance trust is established through a trust deed, the policy holder can draft the deed providing the trustees, beneficiaries and the distribution of the proceeds. In both cases, the trust is not settled until the proceeds of the life insurance policy are paid to the trust upon the death of the policy holder.[26]

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24. In CRA Technical Interpretation 2002-0154435, "Payment of Trust Expenses by Beneficiary", April 17, 2003, CRA considered whether the payment of trust expenses by the spousal beneficiary would taint the trust's status as a testamentary trust. In this case, the spouse was paying operating expenses only in respect of a cottage, in lieu of rent. CRA determined that such payments of operating expenses would not be regarded as a contribution to a testamentary trust; however a capital expenditure in respect of the property would be regarded as a contribution to a testamentary trust.
25. CRA Technical Interpretation 2000-0059795, "Testamentary Trust Variation", November 18, 2001.
26. If the trust is settled prior to the death of the policyholder, then the trust will not be a testamentary trust (CRA Memo 9818696, "*Inter vivos* v. testamentary trusts", August 7, 1998).

CRA has stated that a trust funded from the proceeds of a life insurance policy available on the death of an individual, the terms of which have been established by the individual during his or her lifetime, separate from his or her Will, will be considered a testamentary trust.[27] This view is based on the understanding that no amount is settled on the insurance trust before receiving funds from the insurance policy as a result of the policy holder's death and that the trust is designated as the beneficiary of the life insurance policy. It is not sufficient for the majority of the funds in the trust to have come from the insurance policy.[28] Such an arrangement will result in the insurance trust's losing its testamentary trust status. Therefore, in order to ensure that a life insurance trust is not treated as an *inter vivos* trust for tax purposes, no property can be settled prior to the death of the policy holder. CRA stated:

> . . . where an individual designates a trust as a beneficiary of an insurance policy available on his death, it is our opinion that even though the terms of the trust have been established by an individual during his lifetime and separate from his will, such a trust will be considered as a testamentary trust within the meaning of subsection 108(1) of the Act as it has been created on or after the individual's death or as a consequence thereof. In other words, it is our opinion that the trust will come into existence when insurance proceeds are paid to the trust rather than when the insured designates the beneficiary in the insurance contract.[29]

Similarly, CRA has taken the view that where a trust is funded from the proceeds of an RRSP or RRIF, it may qualify as a "testamentary trust" within the meaning of s. 108(1) of the ITA.[30] CRA stated that in order for a trust funded by the proceeds of an RRIF or RRSP on an individual's death to be viewed as a testamentary trust, the following conditions must be satisfied:

(a) the trust was created by the deceased individual or his legal representative;

(b) the deceased individual has designated the trust as the beneficiary of the RRSP or RRIF;

27. CRA Technical Interpretation 9605575, "Testamentary Trust — Insurance Proceeds", December 17, 1996.
28. CRA Technical Interpretation 2002-0143685 "RRSP/RRIF and testamentary trusts", January 29, 2003.
29. *Supra*, footnote 27.
30. *Supra*, footnote 28.

(c) the designation of the trust as beneficiary of the RRSP or RRIF is considered under the applicable provincial legislation to be a testamentary instrument;
(d) no property was contributed to the trust prior to the receipt of the proceeds of the RRIF or RRSP on the death of the individual; and
(e) no property is contributed to the trust otherwise than by an individual on or after the individual's death and as a consequence thereof.[31]

Proper estate planning may include an insurance trust or trust funded by the proceeds of an RRIF or RRSP. As mentioned above, these trusts, if properly structured, can be testamentary trusts for tax purposes and therefore can take advantage of the graduated tax rates.

4. *Inter Vivos* Trusts

As mentioned above, an *inter vivos* trust for purposes of the ITA is a trust that is not a testamentary trust. *Inter vivos* trusts are generally established by either a Declaration of Trust (where one party declares that he or she is holding certain property in trust for specified beneficiaries on certain terms) or by a Trust Deed or Agreement evidencing a settlement of trust (where one party, the settlor, gives certain property to another party or parties, the Trustees, to hold on trust for the benefit of specified beneficiaries on certain terms). As indicated above, the three certainties must be present in order to establish a trust.

Inter vivos trusts may be used as part of an effective estate plan. This section addresses the following uses of *inter vivos* trusts:
(i) using *inter vivos* trusts to shelter capital gains and to split income; and
(ii) using *inter vivos* trusts in an estate freeze.

(1) Sheltering Capital Gains

Though a capital gain realized on property held in a trust is normally considered part of the capital of a trust under trust law, it is considered a capital gain a portion of which is subject to income taxation under the ITA.[32] Under s. 104(21) of the ITA, a trust that has realized capital gains in a given taxation year can designate any amount of those gains as a taxable capital gain for the year of a Canadian resident beneficiary of a trust. In order to qualify under

31. *Ibid.*
32. ITA, s. 38(*a*).

s. 104(21), the amount designated by the trust must reasonably be considered to be part of the amount of what would otherwise be trust income included in the beneficiary's income. Income of a beneficiary includes amounts included in the income of the trust that is paid or payable to the beneficiary,[33] accumulating income of the trust that is designated to the beneficiary in a preferred beneficiary election,[34] and upkeep or maintenance of a property paid out of the income of the trust that confers a benefit on the beneficiary.[35]

The trust cannot designate amounts exceeding the amount of the trust's net taxable capital gains for the year. Under s. 104(21.3) of the ITA, the net taxable capital gains is the amount by which the trust's taxable capital gains exceed the total of its allowable capital losses for the year and the net capital losses of other years that are deducted by it in determining its taxable income for the year. The designated amount is treated as a taxable capital gain in the hands of the beneficiary. That taxable capital gain can be offset by any allowable capital losses. The trust is then entitled to deduct from its income the amounts paid to the beneficiaries.[36]

When considering any income splitting arrangement, consideration must be given to the attribution rules contained in the ITA, discussed above. Under s. 74.2 of the ITA, capital gains on property transferred to the transferor's spouse, including transfers by means of a trust, are deemed to be capital gains of the transferor and are attributed to the transferor. There is no similar provision to attribute capital gains on property transferred to the transferor's own minor children, directly or through a trust.[37] Thus, capital gains may be designated to minor children who are beneficiaries of a family trust for income splitting purposes. In addition, there may also be the opportunity to multiply the capital gains exemption.[38]

(2) Estate Freeze

Estate freezes are often an important component of *inter vivos* estate planning. Estate freezes may be used as part of an effective estate plan

33. ITA, s. 104(13).
34. ITA, s. 104(14).
35. ITA, s. 105(2).
36. ITA, s. 104(6)(*b*).
37. Under ITA s. 74.1, income on property transferred to a related minor child will be attributed to the transferor.
38. Under s. 110.6 of the ITA, an individual is entitled to a lifetime tax exemption on the shares of a qualifying "small business corporation" covering up to $500,000 of capital gains.

to minimize taxes on death and pass ownership of a business to the next generation or pass future growth on investments to the next generation. As will be discussed below, trusts may be used in an estate freeze to permit certain interested parties to maintain a level of control and flexibility following the freeze.

An estate freeze is generally completed under ss. 85 or 86 of the ITA, depending on the circumstances. Where a business exists, and the common shareholder parent wishes to freeze his or her interest in the business and pass the future growth to his or her children, a reorganization is generally completed under s. 86 of the ITA. In order to complete a s. 86 reorganization, the share capital of an existing corporation is reorganized. In this regard, all of the outstanding shares of a particular class held by the freezor are exchanged for fixed value shares. New common shares (representing the future growth of the corporation) are issued either directly to the beneficiaries of the freeze or to a trust for their benefit.

If a parent wishes to freeze his or her interest in investments and pass the future growth to his or her children, the freeze is generally completed under s. 85 of the ITA. In order for s. 85 to apply, the transferor and the corporation must file an election. To implement a freeze, the investments of the parent are transferred to a privately owned company in exchange for redeemable/retractable shares equal to the value of the investments transferred. The common shares of the company, which will enjoy the future growth, are subscribed for by the children directly or through a trust (the beneficiaries of which are the children).

The effect of the estate freeze from the freezor's perspective is to effectively cap his or her capital gain in the corporation or the investments as at the time of the reorganization. The freezor's capital gain will be limited to the difference between his or her adjusted cost base in the transferred shares prior to the reorganization and the fair market value of the preferred shares as at the date of the freeze. Accordingly, any gain that accrues after the date of the reorganization will benefit the new common shareholders as opposed to the freezor.

Instead of the new common shares of the corporation being issued directly to the beneficiaries (often the children), the current common shareholder may wish to issue the new common shares to a trust for the benefit of the beneficiaries. In this regard, a discretionary trust would be settled for the benefit of the beneficiary or beneficiaries (or multiple trusts may be used if there are multiple beneficiaries).

In general, a trust may be used where the current common shareholder desires flexibility. The trust can be structured such that the freezor can be one of the trustees of the trust, and therefore is in a position to be involved with the administration of the trust. The beneficiaries of the trust can include the issue of the current common shareholder. If the trust generates income, the trustees can decide when, to whom and in what proportions such income should be paid. When the trust assets are ultimately distributed out to the beneficiaries, again the trustees can determine which beneficiaries should receive the property and in what proportion.

In terms of advantages, an *inter vivos* trust is often used in an estate freeze because:

(i) For tax purposes a trust can be a "flow through" vehicle.

(ii) A trust provides for the flow through of capital gains (as discussed above). Therefore, the use of a trust can maximize the number of persons eligible to claim the capital gains exemption.

(iii) If there is the possibility that one of more of the freezor's children or their issue may wish to carry on the business, the use of a trust may provide flexibility with respect to the distribution of the shares in the long term.

The following are potential disadvantages of using an *inter vivos* trust in an estate freeze:

(i) As the trusts are *inter vivos* trusts, any income that is retained in the trust is taxed at the highest marginal rates. However, if all trust income is distributed, this is not a concern.

(ii) There are costs associated with establishing a trust and filing the annual tax return in respect of same.

(iii) Any decisions with respect to the distribution of the trust capital to the beneficiaries must be made within 21 years from the date the trust is established in order to avoid the application of the 21-year deemed disposition rule.

In structuring any trusts to be used in an estate freeze, consideration must be given to who will be the settlor and the trustee or trustees of the trust. Generally, these trusts are structured with three trustees who may make decisions by majority in order to avoid the application of s. 75(2) of the ITA, discussed above.

5. *Alter Ego* Trusts and Joint Partner Trusts

Alter ego and joint partner trusts can be effective estate planning tools. If all the conditions (discussed below) are satisfied, then an individual is permitted to transfer property on a tax deferred basis into an *alter ego* or joint partner trust (*i.e.*, rollover) and there will be no disposition of such property until the date of the individual's death (resulting in a tax deferral). In addition, the assets held in the *alter ego* or joint partner trust will not form part of the individual's estate on his or her death and, therefore, will not be subject to probate.

Alter ego trust is defined in s. 248(1) of the ITA as a trust to which s. 104(4)(*a*) could apply if that paragraph were read without reference to s. 104(4)(*a*)(iii) and s. 104(4)(*a*)(iv)(B) and (C). The result of this definition is that for a trust to be an *alter ego* trust, the following conditions must be met:

(a) the trust must be established after 1999 and must be a Canadian resident;
(b) the settlor must have attained the age of 65 and be a Canadian resident at the time the trust is created;
(c) the settlor must be entitled to receive all of the income of the trust that arises before his or her death; and
(d) no person other than the settlor can, before the settlor's death, receive or otherwise obtain the use of any of the income or capital of the trust.

A joint spousal or common-law partner trust (a "joint partner trust") is similar to an *alter ego* trust and is defined in the ITA as a trust to which s. 104(4)(*a*) would apply if that paragraph were read without reference to s. 104(4)(*a*)(iii) and s. 104(4)(*a*)(iv)(A). Consequently, a joint partner trust has the same conditions (a) and (b) as the *alter ego* trust, but conditions (c) and (d) are expanded to allow for either the settlor or his or her spouse or common law partner to be entitled to receive all of the income of the trust that arises before the death of the survivor of them, and for no other person other than the settlor or his or her spouse or common law partner to be entitled to receive or use any of the trust income or capital prior to the death of the survivor of them.

(1) Benefits of *Alter Ego* and Joint Partner Trusts

(a) Probate

One of the principal uses of *alter ego* and joint partner trusts is the avoidance of the estate administration tax or probate fees.[39] Property held within an *alter ego* or joint partner trust does not form part of the deceased's estate for probate fee purposes because the property passes pursuant to the terms of the trust. Estate administration tax is exigible

39. Under s. 2(6) of the *Estate Administration Tax Act, 1998*, the amount of estate administration tax payable is "(a) five dollars for each $1,000 or part thereof of the first $50,000 of the value of the estate; and (b) fifteen dollars for each $1,000 or part thereof by which the value of the estate exceeds $50,000".

on the value of an individual's estate.[40] "Value of the estate" is defined in s. 1 of the *Estate Administration Tax Act, 1998* as follows:

> "value of the estate" means the value which is required to be disclosed under section 32 of the *Estates Act* (or a predecessor thereof) of all the property that belonged to the deceased person at the time of his or her death less the actual value of any encumbrance on real property that is included in the property of the deceased person.

Section 32 of the *Estates Act*[41] provides that a person applying for a grant of probate must deliver to the registrar a statement of the total value of all the deceased's property at the time of death. Section 32(3) of the *Estates Act* provides that where a grant is limited to only part of the deceased's property, it is sufficient to set forth only that part of the property and the value thereof, which will be affected by the application.

Both the *alter ego* and joint partner trusts may be established such that there are giftover beneficiaries who will receive the income and capital of the trust upon the death of the individual or the individual's surviving spouse or partner. As the assets under the trust pass pursuant to the terms of the trust, these assets do not form part of the individual's estate. This is an effective probate planning tool as these assets would not fall within the estate of the deceased individual (and therefore would not be subject to probate), but would instead pass to the giftover beneficiaries subject to the terms of the trust.

Therefore, particularly if an individual has a large estate, it may be advantageous for some or all of his or her assets to be transferred to the *alter ego* or joint partner trust during the lifetime of the individual. If only some of the individual's assets are transferred to the *alter ego* or joint partner trust, it is important that a Last Will and Testament be drafted for the remaining assets that are not subject to the *alter ego* or joint partner trust to prevent an intestacy with respect to the distribution of such assets.

(b) Privacy

Alter ego and joint partner trusts can also be used to maintain the privacy of the deceased. When property is passed pursuant to a Will and a grant of probate is required, as discussed above the value of the assets must be disclosed and the probated Will is a public document.

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40. Pursuant to the *Estate Administration Tax Act, 1998*, S.O. 1998, c. 34, Sch.
41. R.S.O. 1990, c. E.21, as amended.

If assets are held in an *alter ego* or joint partner trust, the value of the assets is not disclosed.

(c) Creditor Protection

Another potential benefit of *alter ego* and joint partner trusts is that property in the trust may be afforded better protection from creditors. In order to be protected from creditors, the trust must be irrevocable and fully discretionary. Also, in order to avoid any claims of fraudulent conveyance, the trust must not have been created for the purpose of defeating creditors.

(d) Tax

There are also tax implications involved with transferring property to *alter ego* and joint partner trusts. Generally, a transfer of property into a non-spousal *inter vivos* trust that names others as beneficiaries is a disposition by the transferor and acquisition by the trust at fair market value. A transfer of capital property to an *alter ego* or joint partner trust, on the other hand, is eligible as a "qualifying transfer"[42] whereby the trust will be deemed to have received the property at an amount equal to the transferor's proceeds, which will be the adjusted cost base or a proportion of the undepreciated capital cost if the property is depreciable property (*i.e.*, rollover).[43] If the settlor elects out of the rollover,[44] the transfer of property will be deemed a disposition at fair market value. Thus, there is a potential for tax deferral with respect to accrued gains on the assets in the *alter ego* or joint partner trust.

(e) 21-Year Deemed Disposition Rule

As mentioned above, in general trusts are deemed to have disposed of all of their property and re-acquired same at fair market value every 21 years. There is no tax triggered at the twenty first anniversary of the establishment of an *alter ego* or joint partner trust. Thus, if the trust were to last for greater than 21 years following the establishment thereof, the 21-year deemed disposition rule will not apply and the disposition of the trust assets will be further deferred until the death of the individual settlor or his or her surviving partner.[45] The potential for tax deferral beyond the 21-year period is an advantage of *alter ego* and joint partner trusts.

42. ITA, s. 73(1.01)(*c*)(ii) and (iii), s. 73(1.02).
43. ITA, s. 73(1).
44. *Ibid.*
45. ITA, s. 104(4)(*a*)(iv).

(2) Drawbacks of Establishing an *Alter Ego* or Joint Partner Trust

The benefits of establishing an *alter ego* or joint partner trust must be balanced against the drawbacks of such trusts.

(a) Cost

A principal consideration in the decision to establish an *alter ego* or joint partner trust is the cost for the establishment and maintenance of such trusts. As these vehicles are trusts, there are costs associated with establishing and maintaining them (*e.g.*, legal fees to draft the trust instrument, annual trust tax returns, trust accounts, etc.). Thus, if an individual or a couple are considering whether an *alter ego* or joint partner trust is appropriate for them and their primary motive is probate planning, consideration must be given to whether the probate savings will offset the cost of operating the trust.

(b) Testamentary Trust Status

One significant limitation of an *alter ego* or a joint partner trust is the ability to establish a trust on the death of an individual that would qualify as a testamentary trust for the purposes of the ITA. As mentioned earlier, testamentary trusts are taxed at the same marginal rates as individuals, whereas *inter vivos* trusts are taxed at the highest marginal rate. *Alter ego* trusts and joint partner trusts are *inter vivos* trusts, because property is contributed to them during the lifetime of the settlor, and are taxed accordingly.[46]

CRA has stated that a trust created upon the death of the settlor of an *alter ego* trust or upon the death of the survivor of the settlor and the spouse or partner of a joint partner trust will not qualify as a testamentary trust under the ITA.[47] In CRA Technical Interpretation 2001-0079285, "Status of Successive Trusts", CRA stated:

> . . . a trust which is created by the trustees of an *inter vivos* trust pursuant to the terms of that trust would not be a testamentary trust for the purposes of the Act by reason of the exclusion in paragraph (a) of the definition of testamentary trust. Similarly, a trust which receives a contribution from an *inter vivos* trust would not be a testamentary trust for the purposes of the Act by reason of the exclusion in paragraph (b) of that definition.

46. ITA, s. 108(1) "testamentary trust".
47. CRA Technical Interpretation 2000-0005135, "Trust — Property from *Alter Ego* Trust".

> Since it is our understanding that a person cannot transfer his or her property on or after his or her death otherwise than by will or other testamentary instrument, the transfer of property from an *alter ego* trust to a trust created after the death of the settlor of the *alter ego* trust is not a transfer of property by the settlor of that *alter ego* trust. Furthermore, in the case of property which has been transferred to an *alter ego* trust prior to the death of the settlor, the property does not belong to the settlor at the time of the settlor's death and thus, the property cannot be considered to be a contribution by the settlor as a consequence of the settlor's death to a trust that is created subsequent to the settlor's death.

The inability to create a testamentary trust from an *alter ego* or joint partner trust is a significant limitation to the use of such trusts.

(c) Contingent Beneficiaries

Another consideration with *alter ego* and joint partner trusts is that where contingent beneficiaries are included in the trust, these beneficiaries have rights, including the right to require an accounting by the trustees. In the event that the contingent beneficiaries are minors, the Children's Lawyer on their behalf could require an accounting.

6. Conclusions

Trusts continue to be an important part of many estate plans. When determining whether a particular type of trust should be used, the settlor should always keep in mind what his or her personal and financial objectives in establishing the trust are and how the ITA rules governing trusts may affect the realization of those goals.