Trusts: Alter Ego, Joint Partner/Joint Spousal, and Testamentary Trusts for Disabled Children

Prepared for: Legal Education Society of Alberta

Drafting Wills and Trusts

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For presentation in:
Edmonton, Alberta – February 28, 2017
Calgary, Alberta – March 7, 2017
INTRODUCTION

This paper is a discussion of a mélange of trust topics. First, it will discuss drafting considerations pertaining to Alter Ego and Joint Partner or Joint Spousal Trusts. For simplicity, Joint Partner or Joint Spousal Trusts will be referred to as "Joint Partner Trusts". Second, it will consider claims against trusts in the context of matrimonial property law and dependent’s relief, and review current case law. Finally, it will review the use of discretionary trusts, including Qualified Disability Trusts, for disabled children and the laws in Alberta regarding assured income for the severely handicapped.

I. ALTER EGO AND JOINT PARTNER TRUSTS – DRAFTING CONSIDERATIONS

Alter Ego and Joint Partner Trusts are inter vivos trusts that became permissible as a result of provisions that came into force on January 1, 2000 under the Income Tax Act, RSC 1985, c 1 (the "ITA"). These trusts are defined in highly technical language in s. 248(1) of the ITA with reference to s. 104(4)(a). Below is a clearer definition of Alter Ego Trusts from Margaret E. Rintoul's loose-leaf textbook Wills and Estates:

[A] trust created after 1999 by a taxpayer during a taxpayer's lifetime where the taxpayer had attained the age of 65, was entitled to receive all of the income of the trust arising before the taxpayer's death, and no person other than the taxpayer before his or her death could obtain the use of the income or capital of the trust.1

The primary difference between Alter Ego and Joint Partner Trusts is that Joint Partner Trusts can be for the benefit of both the settlor and the settlor's spouse during their combined lifetimes.2 The settlor must be over 65, but there is no age requirement for the settlor's spouse.3 However, only the spouse who is 65 years or older may contribute property to the trust. Joint Partner Trusts cannot be used to split income between spouses. Income from property held in the trust must be allocated to the spouse who contributed the property to the trust.

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2 In this paper, whenever reference is made to the "spouse" of someone in the context of a Joint Partner Trust, this will include a common-law partner of the settlor as defined in s. 104(1) of the ITA. Essentially, a person is the common-law partner of another for tax purposes if they continuously cohabited for one year in a conjugal relationship, or a shorter period but there is a child of the union.

3 Supra, note 1 at § 5.35.
A. **Taxation of Alter Ego and Joint Partner Trusts**

As is so often stated, unlike corporations, trusts are not legal persons. Instead, a trust is more properly described as a legal relationship between the trustee and the beneficiary. However, for Canadian tax purposes, trusts are treated as individual taxpayers. Before drafting, it is important to discuss with clients how Alter Ego and Joint Partner Trusts are taxed. Alter Ego and Joint Partner Trusts may have varying effects on taxes depending on the taxpayer, but in general these trusts are tax neutral.4

In particular, if capital property that has increased in value is transferred to an *inter vivos* trust that is not an Alter Ego or Joint Partner Trust, the transferor (settlor) will incur a taxable capital gain, but the trust will acquire the property at the increased adjusted cost base. If the trust is an Alter Ego or Joint Partner Trust, then the settlor will not incur a taxable capital gain, and the trust will acquire the property at the settlor's cost base. It is possible for the settlor to elect to have the transfer of property take place at fair market value. This may be a preferred option if the settlor wishes to crystallize a gain or loss.

In addition, the usual "21 year deemed disposition" rule does not apply to Alter Ego or Joint Partner Trusts. This rule applies to most other trusts, and provides that the trust is deemed for tax purposes to have disposed of all of its assets every 21 years. If the settlor of an Alter Ego or Joint Partner Trust elects to have the transfer take place at fair market value, then the 21 year rule will apply to the trust.

When an Alter Ego or Joint Partner Trust is created, there will be a deemed disposition of the trust's assets on the death of the settlor of an Alter Ego Trust, or on the death of the last surviving partner or spouse in a Joint Partner Trust. Basically, this is in line with how estates are taxed on the death of a taxpayer, and from that point of view, these trusts do not change how assets are taxed on death. However, there are some important tax considerations in this context. If the trust deed for an Alter Ego Trust directs that capital property of the trust shall pass to the settlor's surviving spouse, the capital gain from those assets will be taxed at the *inter vivos* trust rate. No rollover occurs to the surviving spouse, who, if a trust did not exist, could inherit capital property on a tax deferred basis at the deceased’s adjusted cost base. With a Joint Partner Trust, the deemed disposition does not

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4 Supra, note 1 at § 5.27.
occur until the death of both spouses. As a result, if a client has a spouse who will inherit capital property, for tax purposes it is better to use a Joint Partner Trust than an Alter Ego Trust.\(^5\)

B. Trustees

Typically with Alter Ego and Joint Partner trusts, a settlor will want to be the initial trustee when permitted in the province in which the settlor resides.\(^6\) However, it is possible to appoint a spouse or third party trustee, as with any other trust. In the writer’s experience, this would be unusual.

Certainly, it will be important to include provisions to appoint successor trustees, particularly if the settlor is the original trustee. Alter Ego and Joint Partner Trusts are well known Will substitutes. On the settlor's death, the successor trustee is akin to a personal representative appointed by Will. Similarly, if the settlor loses capacity to manage financial affairs, the successor trustee can continue on with the administration of the trust rather seamlessly, and in this sense is akin to an Attorney pursuant to an Enduring Power of Attorney.

For this reason, great care should be taken in ensuring that appropriate successor trustees are appointed, and specifying when their appointment becomes effective. As with Wills, it is possible to give a third party the power to appoint a successor trustee, rather than the trust deed exhaustively naming individuals to act. As well, clients should address the issue of how (or if) a successor trustee should be compensated. If nothing is specified, then the trustee is entitled to charge “fair and reasonable” compensation pursuant to the Trustee Act, RSA 2000, C.T-8.s.44.

Historically, the residency of a trust for tax purposes was determined by where the majority of the trustees resided, which made it possible to take advantage of lower tax rates in other Canadian jurisdictions simply by appointing trustees who resided in that jurisdiction. As a result of the Supreme Court of Canada decision Fundy Settlement v. Canada,\(^7\) a trust is resident for tax purposes in the jurisdiction where its "central management and control" takes place.

The residence of an Alter Ego or Joint Partner trust for tax purposes is usually of little concern because the settlor(s) will usually wish to remain the primary trustee, and, by definition, all income of the trust must be paid to the settlor or the settlor's spouse. In these instances, the income will be taxed based on his or her place of residence. However, it is possible to have the income taxed in the

\(^5\) Supra, note 1 at § 5.33.

\(^6\) James Kessler & Fiona Hunter, Drafting Trusts and Will Trusts in Canada, 4th ed (Toronto: LexisNexis Canada, 2016) at 253. The authors note that the Succession Law Reform Act, R.S.O. 1990, c. S.26, "provides that the notional value of the net estate includes dispositions made from a trust for which the deceased had control over the disposition of the capital.

trust, rather than in the hands of the settlor/beneficiary. If a third party trustee resides in a lower tax jurisdiction, then income splitting is possible in this case. Also, if the trust includes additional trusts that will continue after the death of the settlor, or the settlor and his or her spouse, then the residence of the trustee may be of greater concern, depending on the value of the trust assets and whether any income will be taxed to the trust.

The trust deed for Alter Ego and Joint Partner Trusts should not give the trustee the power to purchase life insurance with trust assets. If life insurance is purchased on the life of the settlor for the benefit of a spouse, child, or anyone else, the CRA may consider the trust to be for the benefit of someone other than the settlor during the settlor’s life, and could void the trust.

C. Beneficiaries

In order to qualify as an Alter Ego Trust, the settlor must be the sole beneficiary during the settlor’s lifetime. The settlor of an Alter Ego Trust must be entitled to all of the income, and no one except the settlor can receive any of the capital. In most cases, the dispositive provisions of the trust give the settlor the right to receive capital, but this is not necessary. If the settlor is not entitled to receive any of the capital, this could provide a layer of protection against any future creditors, subject to the comments below regarding matrimonial claims.

Where a Joint Partner Trust is involved, the beneficiaries must be the settlor and the settlor’s spouse during their lifetimes, and no one else. On the death of both the settlor and his or her spouse, there will be a deemed disposition of all of the trust’s assets for tax purposes, and the trust can specify to whom the trust property is to be distributed. In this way, the trust serves as a Will substitute which has various benefits discussed later on in this paper.

However, with every benefit comes a cost. Whereas “Alter Ego Trust or Joint Partner Trust, as a Will substitute” may have the advantage of saving estate administration costs, or protecting against various claims, it may also result in a mismatch for tax purposes. For example, if the Alter Ego Trust directs that on the death of the settlor there is to be a gift to a specified charity, the charitable donation credit can only be matched against tax payable by the trust, not by the deceased’s estate. The rules around charitable donation receipts for these trusts are more limited than those applicable to estates. Therefore, the drafter should be cautious when the trust deed includes a gift to charity on the death of the settlor, or the settlor and his or her spouse.

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8 Supra, note 1 at § 5.31.1.
9 Supra, note 1 at para 5.33.