

New Options in Estate Planning — Alter Ego and Joint Partner Trusts

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Careful estate planning can help reduce the tax liability that may arise on your death and help you leave as much as possible to your beneficiaries. Trusts often play an important role in this planning.

Two new types of trusts, called “alter ego” and “joint partner” trusts, can offer flexibility in structuring your affairs and controlling the future use of your property. This *Canadian Tax Letter* discusses the pros and cons of using these trusts for estate planning.

Keep in mind that these proposals are not yet law and aspects of them may change before enactment. For an update on the status of these proposals, please contact your KPMG adviser.

Alter Ego and Joint Partner Trusts

Two new kinds of trusts may be useful as substitutes for wills and powers of attorney and can produce significant benefits in terms of avoiding probate fees and easing difficulties for your survivors or your business while your estate is being settled.

If you are age 65 or over, an alter ego trust can help you keep assets out of your estate without giving up your right to those assets during your lifetime. Under the terms of the trust, all of the income and capital of the trust property will be held and used for your benefit alone. Income and capital gains generated by the trust property will be taxable in your hands, as they would be if you continued to own the assets personally. On your death, the alter ego trust document performs the same function as a will in setting out how the trust assets should be distributed.

In the past, this type of trust was less appealing as a will substitute because the transfer of property to the trust was considered a disposition of the property, triggering tax on any capital gains. But because of recent changes to the tax law, property may be “rolled over” to an alter ego trust without triggering any tax liability.



Consider an Alter Ego or Joint Partner Trust

An alter ego or joint partner trust can be an important part of a tax-effective estate plan. Potential benefits of these trusts include helping you to:

- Avoid probate fees
- Avoid probate proceedings in multiple jurisdictions
- Avoid delays in obtaining probate
- Preserve estate liquidity
- Maintain continuity in the management of your property or business
- Preserve privacy and confidentiality
- Protect against estate litigation
- Provide an alternative to a power of attorney

These ideas are discussed in more detail in the following pages.

A joint partner trust works the same way. Spouses (or common law or same-sex partners) can transfer assets to the trust and remain its only beneficiaries during their lifetimes. No income tax will arise when the property is transferred to the trust and all of the income and capital gains of the trust property will be taxable in the partners' hands during their lifetimes. Be cautious of the attribution rules, which may cause the income to be taxed in the settlor's hands.

If you plan to transfer qualified small business corporation shares or qualified farm property to an alter ego or joint partner trust, keep in mind that the \$500,000 capital gains exemption for these types of property can't be

used by either of these kinds of trusts. To overcome this, you may want to elect out of the rollover provisions to trigger a capital gain and claim the capital gains exemption at the time you transfer the property to the trust.

On the death of the settlor of an alter ego trust or the second partner of a joint partner trust, the trust will be deemed to have disposed of its assets at fair market value, and any capital gains will be taxed in the trust's hands.

Generally, trust assets are subject to a deemed disposition 21 years after the trust was created and every 21 years after that and the trust must pay tax on any capital gains. For alter ego and joint partner trusts, the deemed realization at fair market value will not occur every 21 years but will be deferred until the day on which the settlor or surviving partner dies. If the trust continues to exist, a deemed disposition will occur every 21 years after the death of the settlor or surviving partner.

Since alter ego and joint partner trusts are *inter vivos* trusts (created while the settlor is alive), they pay tax at the highest marginal rate applicable to individuals. Depending on the trust's province of residence, its tax rate in 2001 will vary from about 49% in B.C. to 39% in Alberta.

Benefits of Alter Ego and Joint Partner Trusts

Some advantages of using an alter ego or joint partner trust as a will substitute are as follows:

Avoid probate fees—Assets held by an alter ego or joint partner trust aren't subject to probate fees because they are not included in the settlor's estate.

Probate fees are charged by the courts in each province (except Québec) to grant letters probate, which confirm that the deceased's will is valid and the executor has the authority to administer the estate.

The probate charge generally applies to the total value of an estate's assets at the time of death, without any deductions for debts other than those encumbering real property. In some cases, the assets can be distributed and the estate would up without probate but probate is generally required before third parties such as financial institutions will release property to the executor or estate trustee.

Probate fees are determined as a percentage of an estate's value and can add considerably to the taxes your estate will owe. Since there is no maximum for fees

charged (except in Alberta), probate fees for large estates can be substantial.

Avoid probate proceedings in multiple jurisdictions — If you own assets such as real estate in more than one jurisdiction, such as in Canada and the U.S., your executor may need to apply to admit your will to probate in each jurisdiction where you own property to give your legal representative authority to deal with assets in that jurisdiction. This can be an expensive and complicated process. If title to real estate is held by the trustees of a trust, 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, saving probate and local court fees. Note that most civil law jurisdictions (such as Québec) do not recognize the trust and accordingly the use of a trust in such jurisdictions is generally not advisable.

Avoid delays in obtaining probate — Delays in obtaining probate may create problems for family members or an active business.

Preserve estate liquidity — The court process for probating a will can sometimes take several weeks. During this time, surviving family members may not be able to get liquid assets from the estate that they may need. With a trust, the trustees don't have to wait for probate to distribute assets to the beneficiaries named in the trust document.

Continuity in management of property or business — If you own an active business, delays in obtaining probate may interfere with management of the business. In a trust, title to the assets is already in the name of the trustees and management can continue as before the settlor's death because there is no need for an executor to get probate before he or she can deal with the estate.

Preserve privacy and confidentiality — Once probated, a will becomes part of the public domain. For a nominal fee, any member of the public can obtain a copy of your probated will, which would contain a list and total value of your assets at death. Any privacy that your family previously had regarding its assets could be lost. Trust documents specifying how the trust's assets should be distributed remain private.

Protection against estate litigation — Children or other dependants can challenge a will if they feel that they have not been treated fairly and ask a court to distribute an estate based on the deceased person's moral obligations. With a trust, there is no will to challenge. Though it is also

possible to challenge the legal validity of a trust, it is more difficult to do so.

Alter ego and joint partner trusts can also be advantageous for other purposes, for example, to carry out an estate freeze of a private company.

Things to Watch Out For

When you're considering the advantages of a trust as a will or power of attorney substitute, keep in mind the cost associated with establishing and maintaining the trust. Expenses will include set-up fees, professional fees for legal and accounting advice, possible trustee fees, maintaining accounting records for the trust and filing annual tax returns. Other potential problems to watch out for and possible solutions for them include:

Tax treatment of capital gains — Since an *inter vivos* trust is taxed at a fixed rate of the highest marginal rate for individuals, not graduated rates, the capital gain that arises on the deemed disposition resulting from the settlor's death may bear more income tax than it would if taxed in the hands of the deceased.

Treatment of private company shares transferred to trust — If you're considering transferring private company shares to an alter ego or joint partner trust, especially shares of a holding company for investments, keep in mind that the tax treatment of these shares on your death may not be as beneficial as it would be if you held the shares outside the trust.

May prevent use of testamentary trusts — *Inter vivos* trusts pay tax at the top marginal rate applicable to individuals while testamentary trusts (created on the settlor's death) are subject to graduated rates of tax. If your estate plan involves using several testamentary trusts for income-splitting purposes, an alter ego or joint partner trust which provides for a plan of distribution on death will make it impossible to use testamentary trusts because the property was settled *inter vivos*. In this case, a partially funded alter ego or joint partner trust could be used with a will, leaving enough assets in the estate to fund the testamentary trusts.

Impact on charitable credit planning — In the year of death, a charitable donation credit of 100% of net income is available. If bequests on death are greater than the amount eligible under this limit, the excess may be carried back to the year prior to death to calculate a credit against the tax payable in that year, subject to the same limits. A

trust can also make charitable gifts but is more limited in its use of charitable donation credits since the one-year carryback allowed for donations made in wills is not available for trusts.

Power of Attorney Alternative

Alter ego and joint partner trusts can offer an effective alternative to powers of attorney.

A power of attorney allows you to designate a person who will take control of your financial affairs if you become incapacitated due to illness or injury. If this happens and you do not have a power of attorney, control will yield to a provincial public trustee, which may hamstring your family's ability to access your financial resources. Powers of attorney are usually limited to decisions regarding your finances. In some provinces, (including Ontario and Québec), you can empower a different person to make decisions about your health care and medical treatment.

An alter ego or joint partner trust can offer benefits over a power of attorney or applying to the court to appoint a guardian in the event of incapacity:

- Unlike a power of attorney, the trust agreement is a comprehensive document that sets out the trustee's specific duties and powers.
- A higher standard of fiduciary duty applies to a trustee than to an attorney.
- The trust survives death, but a power of attorney does not.
- Property held under the trust agreement can be managed by the trustees in the event of incapacity without the settlor's involvement; under a power of attorney the individual has the same powers as the attorney.
- The trust offers protection against third party abuse, since the settlor does not have independent control of his or her assets, but he or she can act unilaterally under a power of attorney.

A power of attorney may not be adequate to manage assets outside of your own province — each province and state in North America has different legislation. The authority of a trustee acting on behalf of a trust would be more readily recognized by a foreign bank or other institution.

We Can Help

KPMG's Personal Financial Planning professionals offer comprehensive strategic tax and financial planning advice for high net worth individuals on ways to minimize taxes arising on death and leave as much as possible to their heirs. Services include:

- Income tax planning to minimize income taxes and probate fees arising on death
- Structuring estate freezes - for example, capping the value of a parent's shareholdings of a family company and having the children or a family trust becoming shareholders
- Planning to minimize probate fees arising on death, particularly in provinces such as Ontario and British Columbia where the probate fee percentage is significant
- Reviewing the funding for the taxes and fees arising on death and alternatives to increase or access funding, if applicable
- Will planning and reviews
- Reviewing the potential uses of a trust, for example, to split income among family members and to assist in the protection from creditors (creditor protection has many legal implications and cannot be undertaken without proper legal counsel)
- Reviewing your charitable giving alternatives and the possible uses of a private family foundation.



Canadian Tax Letter

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