



## Alter Ego Trusts

Tony DuMoulin wrote about Alter Ego Trusts in our Winter 2001 issue. Because Alter Ego Trusts can be an important estate planning strategy, we have asked Pat Johnson to submit this piece.

An alter ego trust is a trust created by an individual that takes effect during his or her lifetime, and that meets certain requirements under the *Income Tax Act* (Canada). The person creating the trust (known as the “settlor”) must be 65 years of age or older at the time the trust is created and be resident in Canada for income tax purposes. The trust must also be resident in Canada (which generally means that a majority of the trustees must be resident). Under the terms of the trust, the settlor must be entitled to receive all of the income that arises before the settlor’s death and no person other than the settlor can be entitled to receive any part of the income or capital prior to the settlor’s death.

Similar trusts can be created for the benefit of an individual and his or her spouse or common law partner but, space being limited, will not be discussed here. Provided that the trust meets the requirements set out above, there will generally be no immediate tax consequences to the transfer of assets to the alter ego trust.

The benefits of using an alter ego trust include the following.

- Removing assets from the individual’s estate, thus reducing the assets that may be exposed to a claim by a spouse, common law partner, or child under the *Wills Variation Act*. (This legislation permits any of these persons to challenge a Will on the ground that they were not adequately provided for.)
- Removing assets from the individual’s estate, thus reducing the amount of probate fees payable if the executor is required to obtain probate.
- Minimizing the public disclosure of the individual’s affairs that results from probate.
- Providing an alternative to the appointment of another person under a Power of Attorney to look after the individual’s affairs in the event of his mental incapacity.

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Unlike a Will, a trust of this type is not usually revocable. It is, however, still possible to effect a number of changes after the trust has been established, including:

- effectively winding up the trust by transferring all assets back to the settlor;
- changing the length of time the trust will continue in effect;
- changing the trustees;
- changing the beneficiaries or their interests in the trust property;
- adding further property to the trust, and
- amending the trustees’ administrative powers.

If the trust is still in place at the time of the individual’s death, it will take the place of the individual’s Will, with respect to assets held in the trust. The individual should, however, still have a Will, to deal with any assets that have not been transferred to the trust.

The initial document prepared to bring an alter ego trust into existence is the trust agreement (which will be a “declaration” if the settlor is also the sole trustee, or a “settlement” if there are other trustees). The trust agreement, if well drafted:

- establishes the trust;
- sets out the general framework as to distributions to the beneficiaries;
- confers on the trustees, various powers to pay out income and/or capital, in accordance with the specific provisions of the trust agreement;
- can confer on the settlor, various powers to change the “default”

provisions in this general framework, including the power:

- to wind up the trust earlier than the maximum time period provided in the trust agreement;
- to alter the distribution of income and capital among the secondary beneficiaries;
- to add beneficiaries to the “default list” set out in the trust agreement;
- to exclude as beneficiaries anyone on the original “default list”;
- can confer on the trustees, various powers to change the “default” provisions in this general framework, including the power:
  - to wind up the trust earlier than the maximum time period provided;
  - to amend the administrative powers set out in the trust agreement; and
- can confer on the settlor the power to appoint and remove trustees.

Other, ancillary documents commonly used may include:

- a deed of gift of additional property;
- transfer documents for the specific assets transferred into the trust;
- a declaration of trust by nominees (often used with respect to real estate transferred to the trust where the transfer is not registered);
- a revocable deed of appointment of replacement trustees; and
- a revocable deed of appointment of capital and income. The deed of appointment of capital and income (which can be revoked and changed by the individual during his lifetime) alters the default provisions in the trust agreement as to distribution of income and capital after the death of the individual.

In most cases, the settlor will wish to retain a “capital interest” in the trust, in other words, the ability to receive not just income from the trust but the capital, as well. Where this is the case, the settlor will be taxed on all of the income, gains, and losses of the trust during his lifetime. (This is essentially the same position the settlor would be in if the assets had not been transferred to the trust.)

On the death of the settlor, the alter ego trust will be deemed (for income tax purposes) to have disposed of all of its assets, thus triggering any accrued but not yet realized capital gains. As this gain will be taxed in the trust, and not in the settlor’s estate, it is important to ensure in the initial planning stages that any capital losses that the settlor is carrying forward can be used during his lifetime, because these losses will not be available to offset any gains in the trust.

An alter ego trust is an *inter vivos* trust, not a “testamentary” trust. Accordingly, after the death of the settlor, it will pay income tax at the top marginal rate on so much of its income and gains as are not distributed to its other beneficiaries. Income or gains that are so distributed will be taxed in the hands of the beneficiaries at the rates applicable to them.

In addition to the income tax issues involved in using an alter ego trust, a potential settlor and his advisors must consider the application of property transfer tax. There is no exemption from this tax on registration of a transfer of real estate to the trustees. Accordingly, if a transfer cannot be registered in the names of nominees, utilizing an available exemption, for example, a transfer of a principal residence between “related individuals,” a decision must be made as to whether the probate savings (or other objectives) outweigh the cost of triggering this tax.

Anyone considering the use of an alter ego trust should consult legal professionals and tax specialists regarding his or her specific circumstances. ▲

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## Supporting your Favourite Charity on a Budget

Thank goodness British Columbians give generously to the charitable sector. They recognize that every day in BC, people's lives are enriched by the efforts of not-for-profit organizations, and that financial assistance is essential to support their important work. Donors have to balance their own financial reality with their wish to support a favourite charity, however. Perhaps they are living on a fixed income and, as the cost of living rises, they find themselves in a position where they can no longer provide the same level of financial support.

It is important to remember that the not-for-profit sector is grateful for, and benefits tremendously from, every gift—whether it is \$5 or \$500,000.

### “After-Tax Dollars”

The donor should always think of his or her charitable gift in terms of “after-tax dollars.” Federal and provincial governments provide generous tax incentives for charitable gifts. People who make a charitable donation are entitled to a tax credit in calculating their federal and provincial income taxes. For someone in a relatively modest income tax bracket (37.7 per cent), the after-tax cost of a \$100 donation is roughly \$62 (after the first \$200).

Although you would not realize this saving until after you file your income tax

return, it is certainly nice to know that money you would have otherwise paid to the Canada Customs and Revenue Agency (CCRA) is being directed to a cause you want to support.

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### Deferring the Gift

For people whose financial circumstances prevent them from making an immediate gift to their favourite charity, there are some other very good options. This often involves deferring or postponing the gift. A deferred gift entails the donors making arrangements now for a future gift to a charity. In arranging for this future gift, e.g., through a charitable bequest in a Will, the donors have the satisfaction of knowing they will be helping a charity, without giving up income or assets they may need during their life. The most

common types of deferred gifts are described below.

### The Charitable Bequest

This is done by arranging a charitable gift through a bequest in a Will.

Many people set aside a certain dollar amount. Others leave a percentage of their estate or any assets left over after their families have been provided for. Some people donate an actual piece of property, such as a car or their home.

### Naming a Charity as Direct Beneficiary

Donors can talk to their financial advisor and have the charity named a direct beneficiary of their RSP, RIF, or life insurance policy. This is one of the simplest and easiest ways for the charity to receive the gift because the proceeds of the plan do not need to pass through the estate.

### The All-Important Tax Benefits

Although rarely a motivating factor, the tax savings for the estate can be quite substantial when the charity receives the funds under the terms of a Will or as the beneficiary of a retirement or life insurance plan. In preparing the final income tax return for the deceased, the executor can use the donation receipt to claim a donation tax credit up to 100 per cent of the net income.