Estate and Probate Planning – Using Trusts Tax Efficiently

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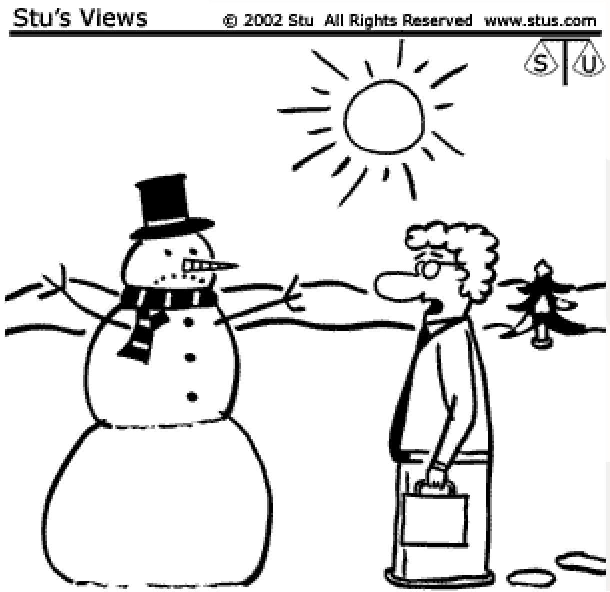

"Mr. Frosty, it's March.
Time to talk estate planning."

What is Estate Planning?

- Planning directed at:
  - Accumulating wealth
  - Transferring wealth to succeeding generations
  - Protecting wealth from unnecessary income and probate taxes and from creditors and others challenging the estate plan

Agenda

- What is a Trust?
- Taxation of Trusts
- Why probate planning?
- Why is this relevant to tax practitioners?
- How do you plan for probate?
- Inter Vivos Trusts
- Family Trusts
- Alter Ego, Joint Partner and Self-Benefit Trusts
- Spousal Trusts
- New s. 104(13.4)
- Testamentary Trusts
- Probate Planning Specifics

What is a Trust?

- A legal relationship whereby one person (the settlor) transfers property to another person (the trustee) to hold for the benefit of others (the beneficiaries)
- The settlor, trustee and beneficiary can all be the same person, but usually two or more persons fill those roles
- A formal trust agreement or trust deed is typically required
- Testamentary trusts are typically established in a will

What is a Trust? (Cont’d)

- Not a separate legal person
- Deemed a person for income tax purposes
- Trustee is a fiduciary and must always act impartially and in the best interests of the beneficiaries
- Trusts can be revocable or irrevocable, fixed interest or discretionary

What is a Trust? (Cont'd)

- Personal family trusts are often discretionary – the trustee decides who among the beneficiaries receives income and/or capital, how much each person receives and when
- Investments by the trustees can be limited or expanded in the trust agreement or left to the "prudent investor" standard in the Trustee Act
- Trusts are private (unlike a probated will) and so preserve confidentiality

What is a Trust? (Cont’d)

- Trust assets are generally free from claims by creditors, including those challenging an estate plan
- A very flexible tool for estate planning
- The main drawback is the settlor’s loss of control over the assets transferred to the trust

Taxation of Trusts

- Detailed and specific rules in the Income Tax Act
- Exceptions to almost every rule
- The settlor generally pays tax on accrued capital gains on assets settled to the trust – a disposition for tax purposes
- Income retained in a trust is taxed at the top marginal rate for individuals

Taxation of Trusts (Cont'd)

- Income paid or payable to beneficiaries is taxed in the hands of those beneficiaries
- The trust receives a deduction for all amounts paid or made payable to the beneficiaries
- If the trust is revocable, or if the settlor retains significant control over the trust assets, all income (including capital gains) is taxed in the hands of the settlor

Taxation of Trusts (Cont'd)

- If the trust is irrevocable and the beneficiaries are under 18 years of age, income (interest and dividends) is taxed in the hands of the settlor, but capital gains can be taxed in the hands of the minor beneficiaries
- Detailed rules apply to the "attribution" of income to the settlor, spouses and minors

Taxation of Trusts (Cont'd)

- All property held by a trust is deemed to be disposed of every 21 years after the year the trust was created and any resulting capital gain (or loss) calculated and taxed

Why Plan for Probate?

- The probate process has built-in delays which can slow down the transfer of assets to beneficiaries
- Probate causes additional professional fees to be incurred
- Probate taxes/fees are typically payable on the total fair market value of the estate assets

Why Plan for Probate? (Cont'd)

- Probate taxes/fees vary from province to province from highest to lowest (top rates below):
  1. Nova Scotia - 1.695%
  2. Ontario – 1.5%
  3. British Columbia – 1.4%
  4. Saskatchewan and Manitoba – 0.7%
  5. Newfoundland and Labrador – 0.5%
  6. New Brunswick – 0.5%
  7. Prince Edward Island – 0.4%
  8. Alberta - $400
  9. Yukon - $140
  10. Quebec - $85

Why Plan for Probate? (Cont’d)

- Enhanced creditor proofing may be gained (including against dependent relief claims that may attach to assets that pass through probate)
- Simplification of administration of domestic estate if assets are already in one succession structure
- Simplification of succession process for foreign assets if have multijurisdictional holdings
- Reduced risk of challenge to deceased’s estate plan on basis of testamentary capacity and undue influence if the alternate succession structure has been put in place well in advance of death

Why Plan for Probate? (Cont’d)

- Continuity of management and administration of assets by successor owners/trustees – no frozen assets which therefore enhances liquidity
- Enhanced incapacity planning compared with a power of attorney – more comprehensive powers, more continuity of management, better protection for the incompetent/beneficiaries, greater recognition in foreign jurisdictions
- And finally, the probate process is public (i.e. Frank magazine) – avoiding it preserves confidentiality

Why Plan for Probate? (Cont'd)

- However, client still needs a valid will and enduring general power of attorney and personal directive to:

1. Address the disposition of assets not covered by alternate succession structures upon death
2. Provide for management and administration of any assets not covered by alternate succession structures in the event of incapacity
3. Provide for personal and healthcare decision making (not covered by any alternate succession plan)
4. Implement any powers of appointment held by the client

Probate - and Probate Avoidance!

Why is this particularly relevant to tax practitioners?

- Probate planning should follow after the tax plan for high net-worth clients for the reasons noted previously
- But, the probate plan can negatively affect the tax plan – caution !
- How do trusts and other structures create opportunities and challenges?

How to Plan for Probate

- Gifts to beneficiaries before death
- Joint ownership with right of survivorship
- Designations of beneficiaries (for RRSPs, RRIFs, TFSAs and insurance policies)
- Trusts established during lifetime – alter ego, joint partner and bare trusts
- Multiple/double wills (possible in some provinces, but not NS)
- Inter-provincial planning to reduce or avoid probate

How to Plan for Probate (Cont'd)

- Caution: unless the probate avoidance transactions occur between spouses so that a spousal rollover is available, the tax implications of each type of probate avoidance mechanism must be addressed

Inter Vivos Trusts

A. What Is it?

- Any trust created by a settlor during her lifetime

B. Tax Implications

- Property transferred to the trust will trigger a capital gain
- Trust is taxed as described earlier

Inter Vivos Trusts (Cont'd)

C. Pros and Cons

- May permit the transfer of assets on death without having those assets pass through probate under the will
- Negative tax implications often make it an unattractive alternative

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Inter Vivos Trusts (Cont'd)

- Could be useful for non-income producing assets such as a cottage property that has not appreciated much since acquisition
- Need to address ongoing maintenance, repairs and other expenses of ownership (i.e. property tax)
- Preserves continuity of ownership

Family Trusts

A. What Is It?

- Not a defined term
- Generally refers to an inter vivos trust which has beneficiaries who are members of the same family
- Each beneficiary can be either an income beneficiary a capital beneficiary or both

Family Trusts (Cont’d)

- Typically used in estate freezes when operating or holding corporations are involved

B. Tax Implications

- Trust purchases shares at fair market value so there is no negative tax implication to using the trust at that time (need an independent settlor to avoid s. 75(2) and be careful around the s. 74 attribution rules re spouses and minors for investment holding companies)
- Ensures flexibility by allowing for dividends to be taxed in the hands of income beneficiaries and for the distribution of shares on a tax-deferred basis to capital beneficiaries

Family Trusts (Cont'd)

- Allows for multiplication of access to the enhanced capital gains exemption for sale of shares of a qualified small business corporation

C. Pros and Cons

- Trustees maintain control of the shares
- Terms of the trust usually provide wide discretion to the trustees to allocate income and capital among the family members

Alter Ego and Joint Partner Trusts

A. What Is It?

- A specific exception in the Income Tax Act makes these types of inter vivos trusts much more attractive
- Alter ego trust – for the sole benefit of settlor during her lifetime
- Joint partner trust – for the joint benefit of settlor and her spouse or common-law partner for their joint lifetimes
- Both of these only applies to individuals over 65 years of age
- Self-Benefit Trust – for the sole benefit of the settlor (cannot have beneficiary named other than settlor)

Alter Ego and Joint Partner Trusts

B. Tax Implications

- **Note: Some of these rules changed on January 1, 2016 – more later!**
- Transfer of assets by the settlor occurs on a rollover basis
- Income/gains on those assets then taxed in the hands of the settlor during her lifetime at her graduated rates and in the trust upon and after death at the highest rate
- The 21 year deemed disposition rule does not apply until after the settlor's death
- The trust is required to file annual income tax returns and report the attribution of income to the settlor

Alter Ego and Joint Partner Trusts (Cont’d)

B. Tax Implications (cont'd.)

- Issues related to double tax – carrying back losses
  - Typical loss carry back rules do not apply (subsection 164(6))
  - Need to rely on the general loss carry back rules in section 111
  - Affiliation is now a concern as the subsection 40(3.61) exception is no longer available
- Issues related to double tax - roll and bump strategies
  - Is a roll and bump/pipeline strategy available?
  - Was control acquired by virtue of someone's death?
- Careful planning is needed when private company shares are held in an alter ego or joint partner trust

Alter Ego and Joint Partner Trusts (Cont’d)

B. Tax Implications (cont'd.)

- Donations made by the trust may be less effective than donations made in the will
  - The donation credit is limited to 75% of the trust's income (versus 100% if through the will)
  - The ability to make donations must be contemplated in the trust and the charity cannot be considered an income or capital beneficiary
  - Timing of death is a concern (ie. December 30th)
  - But can convert capital gain to dividend on shares (by redemption) which then gets 100% deduction when add the gross-up for the dividend tax credit to the 75% limit

Alter Ego and Joint Partner Trusts (Cont'd)

- Spousal and other testamentary trusts have access to the $800,000 (indexed after 2014) capital gains exemption by virtue of subsection 110.6(2) or (2.1); alter ego trusts and joint partner trusts do not
  - On the transfer of such assets to an alter ego or joint partner trust, it would be advisable to elect out of the rollover provisions of subsection 73(1) thereby triggering a capital gain so as to take advantage of the exemption

Alter Ego and Joint Partner Trusts (Cont’d)

C. Pros and Cons

- A tax-effective way to avoid probate
- Assets pass under the trust, not the will
- Can be considered a “will substitute”
- Protects against incapacity
- Substitute trustees maintain continuity of administration of trust assets if settlor becomes incompetent

Alter Ego and Joint Partner Trusts (Cont'd)

- If trust is irrevocable with no power to encroach on capital during settlor's lifetime, will protect the capital (but not income) from creditors
- Main drawback currently is inability to transfer assets to a testamentary trust

Self-Benefit Trust

- Settlor reports all income/gains during lifetime and has a rollover on transfer to trust
- On death, all income/gains attribute to settlor
- Can avoid probate if trust gives settlor a power or appointment by will over trust capital on death
- <u>But</u> if need to probate for any other reasons then likely must include trust assets
- No creditor proofing with a self-benefit trust

Spousal Trusts

A. What Is It?

- Similar to alter ego and joint partner trusts

B. Tax Implications

- Settlor transfers property on a rollover basis on death or on an inter vivos basis to a trust for the sole benefit of her spouse

Spousal Trusts (Cont'd)

- Spouse must be entitled to receive all of the income while alive and not one else can receive income or capital from the trust while the spouse is alive

C. Pros and Cons

- Alternate beneficiaries (i.e. children) can be named on spouse's death
- A way to preserve assets in the event of re-marriage by a spouse (if limit access to capital)

Spousal Trusts (Cont'd)

- Subject to spousal attribution rules if trust is inter vivos
- Can elect out of the spousal rollover provisions if, for example, the property transferred would otherwise qualify for the $800,000 enhanced capital gains exemption for qualified small business corporation shares
- Watch out for new rules in s. 104(13.4) if blended family!

Section 104(13.4)

- Amendments to the *Income Tax Act* first released on August 29, 2014, introduced a new rule in ss. 104(13.4) that is **VERY** problematic
- Applies to alter ego, joint partner and spousal trusts
- Effect of the rule is to:
  - deem the taxable capital gain arising from the deemed disposition of trust property on the death of the settlor/spouse to be the income of the settlor/spouse and not the trust

Section 104(13.4) (Cont'd)

- deem a year end to occur at the end of the day when the settlor/spouse dies and start a new taxation year for the trust the following day
- This rule is effective on January 1, 2016 for deaths that occur after that date
- Department of Finance letter of November 16, 2015, suggests some relief <u>may</u> be coming

Section 104(13.4) (Cont'd)

1. This has several implications for trust planning:

- The primary problem is the possible change of the beneficial interests of the beneficiaries of the trust and the deceased settlor's/spouse's estate
- This will not normally be an issue with an alter ego trust where the terms of the will and the trust are usually the same, nor with a joint partner trust in a first marriage situation where the schemes of distribution of both spouses are usually the same

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Section 104(13.4) (Cont'd)

- It is a problem in a blended family where the ultimate beneficiaries of the trust may be different than the ultimate beneficiaries of the deceased spouse's estate
- Effectively, the deceased spouse's estate bears the tax burden, but the full value of the assets pass through the trust to different beneficiaries
- Further, certain loss carry-back planning is restricted with respect to private company shares as the gain is no longer taxed in the trust, which might have access to the loss on a carry-back basis as noted above

Section 104(13.4) (Cont’d)

- Finally, it is now impossible to make a charitable gift through the trust which can be used to reduce the gain on the deemed disposition as the gift can’t be made in the same tax year (nor even by the same taxpayer!) as the gain
- The only benefit to the rules is to permit the deceased’s estate to use its full graduated tax rates in the year of death
- Need to review all current alter ego, joint partner and spousal trusts to see if these rules create negative consequences

Section 104(13.4) (Cont'd)

- If so, how can those consequences be ameliorated?
- Some trusts may be amendable/revocable
- What if the trust is amendable/revocable but the settlor lacks capacity?
- Others may need court approval for variation – will it be granted if the beneficiaries don't consent?
- Suggested these changes introduced to curtail interprovincial trust planning
- Department of Finance used a cannon to shoot a fly!

Section 104(13.4) (Cont’d)

- Note also s. 160(1.4) added
- Provides that the settlor/spouse and the trust are jointly and severally liable for the taxes owing as a result of s. 104(13.4)
- Minister of Finance notes indicate that the Minister intends that the section will apply so that the trust pays the tax (therefore avoiding the mismatch of tax and assets, but not helping the loss carry-back or lack of charitable gift problems)

Section 104(13.4) (Cont'd)

- CRA has not as yet confirmed that it will apply the section in the way Finance anticipates
- Does an "integration" clause assist by allowing the amount of the tax to be paid from the trust to the deceased settlor's/spouse's estate help?
- Should that be part of our standard drafting?
- Does that "taint" the estate to make it a non-GRE (more later)?
- A real mess!

Testamentary Trusts

A. What Is It?

- Established in the settlor’s will at the time of her death
- Assets pass through the settlor’s estate, but are then transferred to or held by the trustee of the testamentary trust
- Probate tax (1.695% in Nova Scotia) is payable on those assets

Testamentary Trusts (Cont'd)

- Income tax savings far outweigh the probate tax over time

B. Tax Implications

- Testamentary trust can take advantage of the graduated tax rates in the Income Tax Act until December 31, 2015
- Different than an inter vivos trust which pays tax at the highest marginal rate

Testamentary Trusts (Cont'd)

- Depending on type of income earned in the trust and province of residence of the trust for tax purposes, tax savings could have been about $15,000 per year per trust (subject to s. 104(2))
- Could be combined with a spousal trust to create a testamentary spousal trust

Testamentary Trusts (Cont'd)

C. Pros and Cons

- Was useful in many situations:
- Spouses who have significant income in their own name
- Adult children who have significant income of their own (separate trusts for each child are best)
- Access to capital can be as tight or as loose as required
- Income splitting was also a real benefit (through seeding or residual trusts)

Testamentary Trusts (Cont'd)

Continue to be useful:

- To protect assets from marriage breakdown
- To preserve continuity of ownership (i.e. cottage property, family business)
- To benefit charity after assets are no longer needed to support family
- Many other non-tax reasons for them

Testamentary Trusts (Cont'd)

- Used to work equally well for insurance trusts and RRSP/RRIF trusts in terms of rate splitting between trust and beneficiary
- Effective January 1, 2016, several changes apply to testamentary trusts:
  1. Graduated rates for testamentary trusts gone – top marginal rate will now apply to testamentary trusts and grandfathered *inter vivos* trusts (pre-June 18, 1971)
  2. Estates which are "graduated rate estates" or "GREs" will still obtain graduated rates for 36 months – note: this is generally the estate itself, not the trust, though can designate a particular testamentary trust as the GRE (only one GRE per taxpayer)

Testamentary Trusts (Cont’d)

3. Limited exception for qualified disability trusts (specifics beyond the scope of this presentation)
4. Testamentary trusts must now have a calendar year end starting January 1, 2016
   - Existing trusts with non-calendar year ends had a deemed year end on December 31, 2015, as did existing estates that are not GREs (i.e. estates older than 36 months)
   - GREs can still choose an off-calendar year end but they lose the status 36 months post date of death

Testamentary Trusts (Cont'd)

5. Testamentary trusts must now remit quarterly installments – exception for GREs
6. Testamentary trusts will be subject to alternative minimum tax, will have liability for Part XII.2 tax, and will no longer be able to make investment tax credits available to beneficiaries

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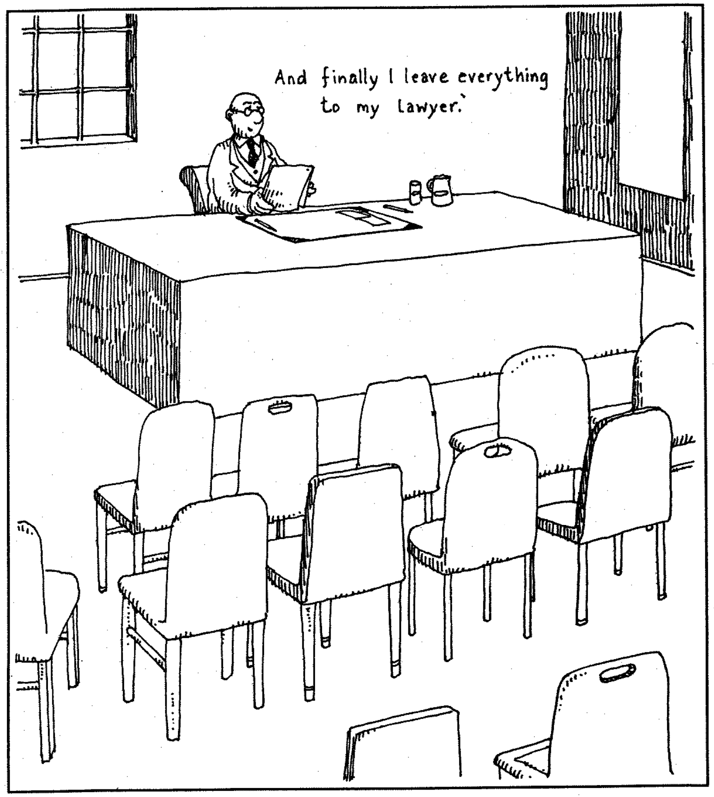
Testamentary Trusts (Cont'd)

- Still very many estate planning reasons for testamentary trusts (such as matrimonial claim protection, spendthrift beneficiaries, blended families, continuity of ownership, incapacitated or vulnerable beneficiaries, U.S. estate tax by-pass, avoidance of double probate, creditor proofing for beneficiaries, etc.)
- Income tax benefits limited, though
- Still have some income tax benefits in certain cases:

Testamentary Trusts (Cont'd)

1. "Estate fund" type trusts for income splitting/sprinkling among class of beneficiaries
2. "Top up" trusts to maximize use of beneficiary's graduated rates
3. Income "paid or payable" to a minor
4. Limited exception for trust for a disabled beneficiary


And finally I leave everything to my lawyer.

Probate Planning Specifics

- Gifts
- Joint ownership
- Beneficiary designations
- Insurance & RRSP trusts
- Alter ego & joint partner trusts
- Bare trusts
- Client Checklist
- Conclusion

Gifts

A. The Strategy

- Gifts made during lifetime avoid probate in the estate of the donor
- Cannot be probated on what you do not own!

B. Tax Implications

- No gift tax in Canada, but donor is deemed to dispose of the asset at fair market value, triggering any gain (or a loss)
- Effect is a prepayment of income tax
- Consider superficial loss rules and attribution rules for gifts to a spouse or minor children
- May be an opportunity for a gift of assets with inherent capital loss to an adult child as there is no attribution

Gifts (Cont'd)

C. Compliance Issues

- Need to document the intention to gift the beneficial interest in the asset and then effect an actual transfer of legal title to the donee
- A deed of gift or equivalent instrument is recommended

D. Pros and Cons

- Simple
- But, if you have given it away you cannot get it back!
- May be appropriate when death is near – no tax prepayment penalty

Joint Ownership

A. The Strategy

- Joint tenancy with right of survivorship (JTWROS) is one of the most common ways to avoid probate
- Can be used for most types of capital property
- Can hold assets JTWROS as between anyone (not just spouses)
- Separation of legal and beneficial title creates opportunities for probate avoidance planning

Joint Ownership (Cont'd)

- SCC in *Pecore* and *Madsen* cases clarified certain presumptions that apply when two persons hold property JTWROS
- If spouses, presumption of advancement applies – upon death of one joint owner the other obtains legal title by operation of law pursuant to the joint tenancy and is presumed to acquire the beneficial interest as well
- If parent and adult child, presumption of resulting trust applies - upon death of parent child is presumed to hold the beneficial interest in the asset on resulting trust for the parent's estate notwithstanding the child obtains sole legal title by operation of law
- Both presumptions can be rebutted

Joint Ownership (Cont'd)

B. Tax Implications

- **Option 1:** if parent's intention on making the asset JTWROS is to immediately gift a beneficial interest to child, creates an immediate disposition for tax purposes in the hands of the parent, triggering any inherent capital gain (based on proportionate interest given away by parent) plus both parent and child must report a proportionate amount of income and gains from the asset in the future while parent is alive

Joint Ownership (Cont'd)

- **Option 2:** No immediate transfer of beneficial interest to child, but intention to pass beneficial interest to child upon parent's death by survivorship
  - child gets beneficial asset on death of parent outright

- **Option 3:** No immediate transfer of beneficial interest to child and no intention to pass beneficial interest to child upon parent's death (child holds interest in trust for parent's estate)
  - asset can be dealt with by child without probate (likely) and could fund testamentary trusts

Joint Ownership (Cont'd)

- Neither Option 2 or 3 triggers a disposition of beneficial interest during the parent's lifetime and parent continues to report all income and gains during lifetime and upon death

C. Compliance Issues

- If Option 2, parent must document the intention to rebut the presumption of resulting trust
- If Option 3, should have child confirm that she holds her interest in the asset in a bare trust for the parent during the parent's lifetime and for the estate thereafter (more later) rather than rely on the presumption of resulting trust

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Joint Ownership (Cont'd)

- Best practice is to clearly document transferor's intention at the time asset made JTWROS or in transferor's will

D. Pros and Cons

- There are potential pitfalls of making an asset legally <u>and beneficially</u> owned by parent JTWROS with adult child (Option 1):

Joint Ownership (Cont'd)

1. Loss of control by parent
2. Potential exposure to child's creditors
3. Disputes among siblings over intentions
4. Death of child before parent
5. Tax implications

Beneficiary Designations

A. The Strategy

- Applies to limited types of assets:
  - Insurance policies, segregated funds and related insurance assets under the provincial *Insurance Acts*
  - RRSPs, RRIFs, TFSAs (as of January 1, 2009), pensions and related retirement savings vehicles under various provincial statutes (i.e. *Beneficiaries Designation Act* in Nova Scotia)
- Assets will pass outside of probate directly to the designated beneficiary upon the death of the insured/annuitant
- If more than one designation, the later in time designation will apply

Beneficiary Designations (Cont'd)

- Can have multiple beneficiaries and primary and contingent beneficiaries
- Note: Consider naming the alter ego/joint partner trust as the contingent beneficiary

B. Tax Implications

- Insurance proceeds pass tax free
- Registered investments will rollover to a spouse, but will otherwise trigger tax on a full income inclusion basis in the estate of the deceased annuitant
  - the tax falls on the estate but the asset passes outside of the estate to the beneficiary without any withholding tax – a potential mismatch of the incidence of tax which needs to be addressed as part of the overall estate plan

Beneficiary Designations (Cont'd)

- Beneficiaries receive the insurance or registered plan proceeds in their own name and are then taxed personally on all the future income and gains on those assets

Beneficiary Designations (Cont'd)

C. Compliance Issues

- Important to keep designations current with changing circumstances (i.e. separation/divorce, death of beneficiary)

D. Pros and Cons

- Simple, but may eliminate income splitting opportunities
- Problems can occur if beneficiaries predecease the insured/annuitant (ie. one of three children predeceases) or proposed beneficiaries are minors or spendthrifts
- Insurance and RRSP trusts used to be attractive alternatives

Alter Ego and Joint Partner Trusts

A. & B. The Strategy and Tax Implications

- Discussed previously

C. Compliance Issues

- Trust only covers assets transferred to it – need to ensure all settlor's assets are held in the trust if it is to be a true "will substitute"

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Alter Ego and Joint Partner Trusts (Cont'd)

D. Pros and Cons

- Protects against incapacity with respect to the assets in the trust
- Substitute trustees maintain continuity of administration of trust assets if settlor becomes incompetent
- Enhances creditor proofing in the estate (including for dependent relief claims)
- If trust is irrevocable with no power to encroach on capital during settlor's lifetime, will protect the capital (but not income) from settlor's creditors
- Consider ramifications of s. 104(13.4)

Bare Trusts

A. The Strategy

- A true bare trust involves transfer of legal title of an asset by one person (the owner) to another person or persons (the "trustee") while retaining beneficial interest in the asset
- Really an agency relationship between owner and "trustee"
- Can arise in the context of making an asset JTWROS between owner and trustee as well as noted earlier
- For probate purposes, legal title in that asset is transferred to the trustee and it is therefore not probateable in the owner's estate upon the owner's death

Bare Trusts (Cont'd)

- Trustee signs a declaration of bare trust confirming intention not to obtain any beneficial interest in the asset
- Trustee is holding the asset in trust for the owner during her lifetime and then for her personal representatives (executors) after death
- Trustee(s) is usually the personal representative(s) as well
- A nominee holding company can be used as the bare trustee in more advanced planning (including a JTWROS arrangement for legal title to the shares of the nominee holdco among various individuals who are the ultimate executors) – watch out for possible loss of assessment CAP here

Bare Trusts (Cont'd)

- Bare trusts can be used for investment accounts, bank accounts, private company shares and real estate

B. Tax Implications

- A bare trust, because it does not transfer any beneficial interest to the trustee during the owner's lifetime, does not trigger a disposition in the owner's hands until the owner's death
- Taxes are reported at that time based on the deemed disposition at fair market value in the owner's estate on the terminal tax return
- Owner reports income and gains from the asset during her lifetime

Bare Trusts (Cont'd)

C. Compliance Issues

- **One major drawback – if any asset needs to be probated, then generally all assets beneficially owned by the deceased need to be probated notwithstanding they may be held in the bare trust**
- **Extreme caution must be used to ensure all assets are outside of probate one way or another!**
- Bare trust arrangements should always be documented clearly in writing by a declaration of bare trust signed by the trustee

Bare Trusts (Cont'd)

D. Pros and Cons

- Why use a bare trust versus a regular JTWROS strategy (Option 1 or 2)?
- Ease of continuity of successor ownership and transfer of beneficial ownership with gift overs in a will
- Assets in the bare trust move into the estate, allowing loss planning and charitable gifting to occur without concern for s. 104(13.4), plus can then fund testamentary trusts created in a will notwithstanding that will is not probated
- A very powerful tool if used properly

Bare Trusts Versus Alter Ego/Joint Partner Trusts

1. Certainty re probate avoidance
   - AET/JPTs clearly cover what is in them – bare trusts can be broken if an asset that requires probate is left out
2. Ongoing trusts in AET/JPT versus will
   - As of January 1, 2016, there is no difference in taxation – both taxed at high tax rate on income retained in the trust with ability to allocate/pay income or make it payable to beneficiaries to “top up” their income and reduce/eliminate taxable income in the trust

Bare Trusts Versus Alter Ego/Joint Partner Trusts (Cont’d)

- “Estate Fund” type trust can work under both structures for income splitting/sprinkling with multiple beneficiaries (i.e. children and grandchildren)
- Continue to be estate planning applications for spendthrifts, Henson trusts, U.S. estate tax bypass, creditor protection, etc. - appropriate in either structure

Bare Trusts Versus Alter Ego/Joint Partner Trusts (Cont'd)

3. Post-mortem tax planning for private company shares not as easy with AET/JPT
   - Subsection 164(6) does not apply to an AET/JPT – must rely on general loss carry-back rules in s. 111
   - Consider affiliation issues as ss. 40(3.61) exception is no longer available
   - Plus deemed year end on death of settlor/spouse creates timing challenges
   - Is a roll and bump-pipeline strategy even available? Was control acquired by virtue of someone's death?

Bare Trusts Versus Alter Ego/Joint Partner Trusts (Cont'd)

4. Capital gains exemption not available in AET/JPT at death of settlor/spouse
   - Must elect out of the rollover in ss. 73(1) on the transfer of shares into the trust to access the exemption
5. Timing of death an issue (though can't do much to plan for it)
   - Deemed disposition that arises on death of the settlor/spouse of an AET/JPT will now be taxed in hands of settlor/spouse and year end will occur

Bare Trusts Versus Alter Ego/Joint Partner Trusts (Cont'd)

- Be careful in blended family situations as s. 160(1.4) may not save you
- Consider drafting around s. 104(13.4) to avoid losing GRE status for settlor/spouse's estate – vest the tax amount by formula in the settlor/spouse

6. Charitable giving was much more circumscribed with an AET/JPT until January 1, 2016 – now impossible!
    - Donation credit was limited to 75% of the trust income versus 100% if through the estate/will (but if own private company shares that can be redeemed, then, with the dividend tax credit gross-up, the 75% limit could be increased to 100% on those assets)

Bare Trusts Versus Alter Ego/Joint Partner Trusts (Cont'd)

- Pre 2016, must draft with discretion (typically coupled with a letter of wishes) in order to obtain any donation receipt for the trust – CRA will otherwise consider a directed gift to be a distribution to an income or capital beneficiary (the "credit problem")
- Pre 2016, timing of death is a concern as can only make the gift out of the trust in the same tax year as the donation (the "timing problem") – given year end occurs on date of death of settlor/spouse, this means credit only available to trust's taxable income in the year <u>after</u> death
- New estate donation rules (5 year window) <u>not</u> applicable to a trust, only a GRE

Bare Trusts Versus Alter Ego/Joint Partner Trusts (Cont'd)

7. Consider whether an AET/JPT should be a charitable remainder trust
   - Would require drafting to limit capital encroachment to an ascertainable amount (or zero) such that you get a tax credit for the present value of the future donation at the time of settlement
   - Trust must be irrevocable
8. Avoiding dependent relief claims better addressed in an AET/JPT
   - Because the TFMA only applies to assets that pass by will (including those that are in a bare trust structure), only an AET/JPT will avoid such claims

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Client Checklist

- Want confidentiality generally – various strategies can work
- Over age 65 and want outright gifts after death (and not blended family) - alter ego or joint partner trust
- Have significant non-registered assets and want testamentary trusts for spouse/children or have large charitable gifts – bare trust

Conclusion

- Estate planning generally and probate avoidance planning specifically are customized processes – each plan is unique
- Various tools are available to maximize the benefits and minimize the risks
- Can combine strategies as part of hybrid planning (i.e. combine an alter ego trust for certain assets with a JTWROS bare trust for private company shares and to provide for charitable gifts
- The goal is to create a customized plan that is best for each client's personal circumstances

"Well, we've licked taxes—that just leaves death."

Questions

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