Should You Be Trusted?
Using Trusts in Estate Planning

CBA NS ELDER LAW CONFERENCE

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PRESENTED BY: RICHARD NIEDERMAYER

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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)
- Not a separate legal person
- Deemed a person for income tax purposes
- Trusts can be revocable or irrevocable, fixed interest or discretionary
- A very flexible tool for estate planning

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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

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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
- Detailed rules apply to the "attribution" of income to the settlor, spouses and minors
- 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

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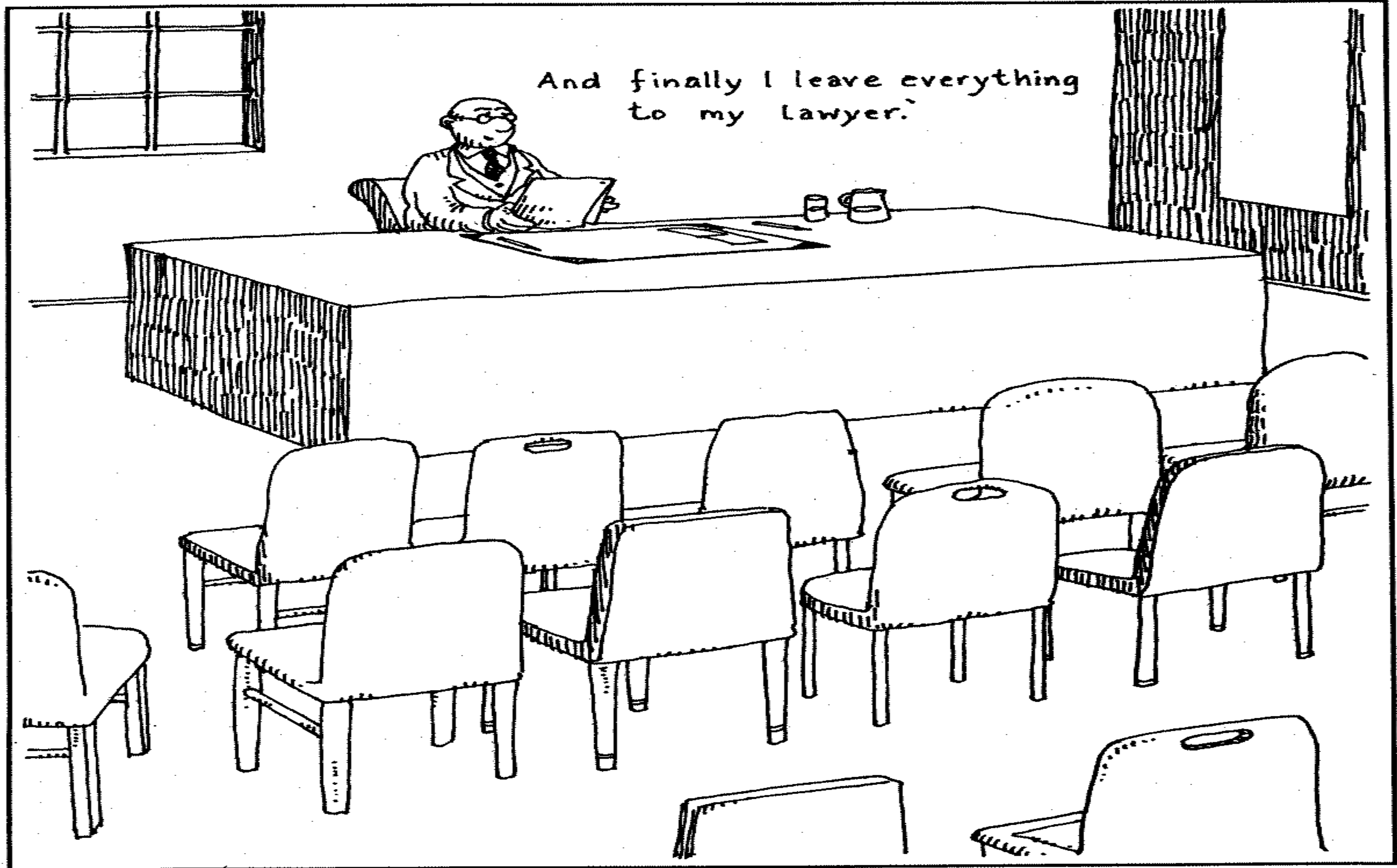

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Why Plan for Probate?

- 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 are generally payable on the total fair market value of the estate assets
- Enhanced creditor proofing may be gained (including against dependent relief claims that may attach to assets that pass through probate)
- 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

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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 and better protection for the incompetent/beneficiaries
- And finally, the probate process is public (just read any edition of Frank magazine!) – avoiding it preserves confidentiality

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Why Plan for Probate? (Cont'd)

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

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 exercisable by will held by the client

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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
- Only applies to individuals over 65 years of age
- 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

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Alter Ego and Joint Partner Trusts (Cont'd)

B. Tax Implications

- 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
- **Can you create a testamentary trust from the property of an alter ego or joint partner trust through a power of appointment exercisable by will?**

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Alter Ego and Joint Partner Trusts (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 moved to an alter ego or joint partner trust

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Alter Ego and Joint Partner Trusts (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 (i.e.. 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

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Alter Ego and Joint Partner Trusts (Cont'd)

- Spousal and other testamentary trusts have access to the $800,000 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

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Alter Ego and Joint Partner Trusts (Cont'd)

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
- **Main drawback is inability to transfer assets to a testamentary trust**

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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 (1.645% in Nova Scotia) is payable on those assets

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Testamentary Trusts (Cont'd)

B. Tax Implications

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

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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 can be about $15,000 per year
- Can be combined with a spousal trust to create a testamentary spousal trust

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Testamentary Trusts (Cont'd)

- Income tax savings far outweigh the probate tax over time (under current rules at least – stay tuned!)
- Will still be a great many uses for testamentary trusts even if separate graduated rates for them are eliminated, and some tax planning opportunities too – more to come!

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Testamentary Trusts (Cont'd)

C. Pros and Cons

- 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)

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Testamentary Trusts (Cont'd)

- 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
- Access to capital can be as tight or as loose as required
- There does not need to be a lot of income producing assets placed in a testamentary trust to be tax effective if there are no trustee fees taken and the only extra cost is filing a tax return

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Insurance Trusts

A. What Is It?

- A form of testamentary trust funded with the proceeds of an insurance policy (or policies) payable on death of the testator
- For personal (not corporate) owned insurance
- Executor and trustee of the will is designated as beneficiary "in trust" in the will or in a separate designation
- Terms of the trust can mirror the terms of testamentary trusts for spouse, children or other beneficiaries in the will or have separate terms (this may maximize income splitting opportunities for the beneficiaries)

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Insurance Trusts (Cont'd)

- If the trust is funded only from the proceeds of a life insurance policy, the terms of the trust have been established by an individual during his or her lifetime and the trust is separate from that individual's estate, CRA will treat that trust as a separate testamentary trust
- If the beneficiary is the executor and trustee (not "estate"), then the policy proceeds will also pass outside of probate (see s. 84A of the Probate Act)

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Insurance Trusts (Cont'd)

B. Tax Implications

- If the trust is settled by the insurance proceeds on death and no one else has, or will, contribute property to the trust, the insurance trust will benefit from testamentary trust status
- Insurance proceeds will be received on a tax free basis by the trust

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Insurance Trusts (Cont'd)

C. Pros and Cons

- Policy also retains its creditor exempt status under the applicable *Insurance Act* provided the beneficiaries of the trust are from the prescribed class of family members (spouse or common-law partner, child, grandchild or parent)

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Insurance Trusts (Cont'd)

- Useful in many situations:
  - Spouses who would otherwise name each other as direct beneficiaries of existing policies – an insurance trust creates income splitting opportunities for the surviving spouse that would not otherwise exist
  - Testators with adult children who may also benefit from income splitting
  - Testators with minor children who need testamentary trusts for estate planning purposes more than tax purposes

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RRSP Trusts

A. What Is It?

- Similar principles apply to testamentary trusts created with registered plan proceeds (RRSPs or RRIFs)
- Executor and trustee can be designated as beneficiary of the RRSP “in trust” on the same terms as the insurance trust noted previously
- RRSP proceeds still pass outside the estate from a probate perspective because they have a designated beneficiary
- Once paid out to the trustee, the plan proceeds will be a testamentary trust provided the same conditions as with an insurance trust noted previously are met

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RRSP Trusts (Cont'd)

B. Tax Implications

- **Caution – the fair market value of the plan as of the date of death will still be taxed as income in the testator's estate on the terminal tax return, even if a spouse or common-law partner is the beneficiary of the trust – there is no rollover to the trust**
- The estate will pay the tax notwithstanding that the separate trust receives the proceeds – this needs to be addressed as part of the overall estate plan

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RRSP Trusts (Cont'd)

- There have been proposals suggested by various professional bodies recommending changes to the ITA to permit a rollover of an RRSP to a spousal trust to preserve the non-tax benefits of using a spousal trust, particularly in a second marriage situation, without deregistering the plan and paying tax prematurely
- Until a legislative change occurs, caution should be used

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RRSP Trusts (Cont'd)

C. Pros and Cons

- RRSPs retain existing creditor protection while the beneficiary designation is in force

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RRSP Trusts (Cont'd)

- This strategy may be useful for annuitants who have no spouse and would otherwise designate children or other beneficiaries directly and thereby miss the income-splitting benefits of a testamentary trust

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Insurance and RRSP/RRIF trusts

- **1** - should the document creating the trust be a "testamentary instrument" under applicable provincial laws?
- **2** - if so, is placing the designation directly in the will preferable?

- See ss. 108(1) of the ITA re definition of "testamentary trust" – trust "arose on and as a consequence of the death of an individual" (but see TI 2003-0007365 re RRSP/RRIF trusts and the need for a testamentary instrument under provincial law)

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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
- Could be considered an agency relationship between owner and "trustee"
- Can arise in the context of making an asset JTWROS between owner and trustee as well
- 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

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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)
- Consider the assessment CAP for land

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Bare Trusts (Cont'd)

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

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Bare Trusts (Cont'd)

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

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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 – do not rely on *Pecore* assumptions with adult children!

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Bare Trusts (Cont'd)

D. Pros and Cons

- Why use a bare trust versus a regular JTWROS strategy?
- Ease of continuity of successor ownership and transfer of beneficial ownership with gift overs in a will
- Assets in the bare trust can fund testamentary trusts created in a will notwithstanding that will is not probated – a significant income splitting advantage
- A very powerful tool if used properly

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Client Checklist

- Want confidentiality generally – various strategies can work
- Over age 65 and want outright gifts after death - alter ego or joint partner trust
- Have significant personal life insurance – insurance trust for spouse/children
- Have registered assets, no spouse but have children – RRSP trust (but be mindful of the tax at death)
- Have significant non-registered assets and want testamentary trusts for spouse/children or others bare trust

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Conclusion

- Estate planning is a 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 non-income producing assets with a JTWROS bare trust for income producing investments, coupled with an insurance trust for a large life policy)
- The goal is to create a customized plan that is best for each client's personal circumstances

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Questions

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Contact Information

Richard Niedermayer, TEP
Partner
Stewart McKelvey
Purdy's Wharf, Tower I
1959 Upper Water Street, Suite 900
Halifax, Nova Scotia B3J 3N2
RNiedermayer@stewartmckelvey.com
Tel: 902-420-3339
www.stewartmckelvey.com

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