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THE FAMILY LAW IMPLICATIONS OF ESTATE PLANNING STRATEGIES: THE NET FAMILY PROPERTY FREEZE, ALTER EGO TRUSTS AND JOINT PARTNER TRUSTS

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The House of Lords, in *Inland Revenue Commissioners v. Westminster (Duke)* established the following fundamental principle of tax law:

> "Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be."[1]

People over the age of 60 have generally amassed the maximum wealth to be had in their lifetime and have planned prudently for their retirement, and ultimately their passing. As noted by John-Paul Boyd and Anna Laing, "ours is an aging population" and more people over the age of 60 are divorced or separated than ever before.[2] While estate planning is both a legitimate and encouraged practice in Ontario,[3] it is imperative to acknowledge the family law implications of the various estate planning strategies for a client who seeks to order their affairs in an effort to undermine their family law obligations prior to or upon the breakdown of a relationship.

Here we will examine the more common estate planning practices, their respective advantages and disadvantages and the treatment of these strategies by the courts in the context of the equalization of net family property. Part I will provide the statutory framework, under which the entitlement to an equalization of net family property arises. Part II will investigate the net family property freeze and the reticence of judges to deem 'gifted' freeze shares as an exclusion from net family property. Part III will analyze the utility of alter ego and joint partner trusts and the treatment of trust assets by the judiciary when equalizing net family property. Part IV will conclude by offering some practice tips, which may bridge the exposure gap between estate planning and avoiding family law obligations.

PART I: THE EQUALIZATION OF NET FAMILY PROPERTY

In the eyes of the court, a relationship is at an end upon the earlier of the following events:

(a) The date the spouses separate and there is no reasonable prospect that they will resume cohabitation;

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[1] *Inland Revenue Commissioners v. Westminster (Duke)*, [1936] A.C. 1 (H.L) at p. 19.

[2] John-Paul Boyd and Anna Laing "The Boomers are Coming: Economic and Other Issues of Older Individuals" (Paper presented to the National Judicial Institute Family Law Seminar: Financial and Property Issues, 4-6 February, 2015) at p. 1 and 3.

[3] As pointed out by Martin Rochwerg and Leela A. Hemmings in "Trusts, Trustees, Trusteeships III: Use of Trusts as Will Substitutes" (Paper, 23 September 2008) [unpublished] ("Trusts") at p.2, "courts in other provinces have been less planner-friendly".

(b) The date a divorce is granted;

(c) The date the marriage is declared a nullity;

(d) The date that one of the spouses commences an application under subsection 5(3) (improvident depletion) that is subsequently granted; or

(e) The date before the date on which one of the spouses dies leaving the other spouse surviving.[4]

In *Schreyer v. Schreyer*, the Supreme Court of Canada succinctly described the legislative efforts to construct a regime for the division of property upon the breakdown of a relationship:

> "Every Canadian province has tried to address in some way the inequities or difficulties arising out of the distribution of family assets after the breakdown of a marriage or of a common law relationship to which the same rules apply. Broadly speaking, the provincial legislatures have chosen between two different models: equalization and division of property."[5]

In Ontario, the *Family Law Act* (the "*FLA*") governs the division of property upon a breakdown of a relationship. The preamble of the *FLA* establishes its primary objectives as *inter alia*, the recognition of the equal position of spouses as individuals within marriage and of marriage as a form of partnership, and to provide in law for the orderly and equitable settlement of the affairs of spouses upon the breakdown of a relationship.[6] In setting the intention for an equalization scheme, the *FLA* recognizes that

> "child care, household management and financial provision are the joint responsibilities of the spouses and that inherent in the marital relationship there is equal contribution, whether financial or otherwise, by the spouses to the assumption of these responsibilities, entitling each souse to the equalization of net family properties."[7]

The equalization of net family property is calculated per section 5(1) of the *FLA,* which stipulates that the spouse whose net family property is the lesser of the two net family properties is entitled to one-half the difference between them.[8]

'Net Family Property' is defined at section 4(1) of the *FLA* as the value of all property, except excluded property, that a spouse owns on the valuation date, after deducting the spouse's debts and other liabilities and the value of property, other than a matrimonial home, that the spouse owned on the date of marriage, after deducting the spouse's debts and other liabilities, other than

[4] *Family Law Act*, R.S.O. 1990, c. F.3 ("*FLA*") at s. 4(1) "valuation date".
[5] *Schreyer v. Schreyer,* [2011] S.C.J. No. 35 (S.C.C.) at para. 14.
[6] *FLA*, *supra* note 4 at "Preamble".
[7] *Ibid* at s. 5(7).
[8] *Ibid* at s. 5(1).

debts or liabilities related directly to the acquisition or significant improvement of a matrimonial home, calculated as at the date of marriage.[9]

The assets constituting "Excluded Property" that are relevant to our present purposes are set out in section 4(2) of the *FLA* as follows:

(a) property, other than a matrimonial home, that was acquired by gift or inheritance from a third person after the date of marriage;

(b) income from property referred in paragraph (a), if the donor or testator has expressly stated that it is to be excluded from the spouse's net family property; and

(c) property, other than a matrimonial home into which property referred to in paragraphs (a) and (b) can be traced.[10]

Pursuant to section 5(6) of the *FLA*, however, the court retains its discretion *not* to equalize net family properties in the event that the court is of the opinion that doing so would be unconscionable, having regard to the following equitable considerations:

(a) a spouse's failure to disclose to the other souse debts or other liabilities existing at the date of the marriage;

(b) the fact that debts or other liabilities claimed in reduction of a spouse's net family property were incurred recklessly or in bad faith;

(c) the part of a spouse's net family property that consists of gifts made by the other spouse;

(d) a spouse's intentional or reckless depletion of his or her net family property;

(e) the fact that the amount a spouse would otherwise receive under the equalization regime is disproportionately large in relation to a period of cohabitation that is less than five years;

(f) the fact that one spouse has incurred a disproportionately larger amount of debt or other liabilities than the other spouse for the support of the family;

(g) a written agreement between the spouses that is not a domestic contract; or

(h) any other circumstances relating to the acquisition, disposition, preservation, maintenance or improvement of property.[11]

In *Ward v. Ward*, the Ontario Court of Appeal emphasized that the discretion to order an unequal division of net family property pursuant to section 5(6) is strictly limited:

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[9] *Ibid* at s. 4(1).
[10] *Ibid*at s. 4(2) (a)(b) and (e).
[11] *Ibid* at s. 5(6).

> "The case law has made it clear that the intent of the section is not to alleviate every situation that may be viewed as in some ways unfair or inequitable, because equal sharing should occur in most cases. The *Family Law Act* creates a scheme for property sharing upon marriage breakdown that is intended to promote predictability and thereby discourage litigation. If courts were to deviate from the scheme of the *Act* wherever it gave rise to an unfair result, this would have the undesirable effect of encouraging parties to litigate their claims."[12]

Equalization of Net Family Property During Cohabitation

Section 5(3) of the *FLA* provides, that if during cohabitation there is a serious danger that one spouse may improvidently deplete his or her net family property, the other spouse may apply to have the difference between the net family properties divided as if the spouses were separated and there were no reasonable prospect that they would resume cohabitation.[13]

As interpreted by the Ontario Court of Appeal in the seminal case of *Stone v. Stone*, the effect of section 5(3) of the *FLA* is that where separation or death is certain, a spouse is under a duty not to deplete his or her net family property.[14] Section 5(3) of the *FLA* therefore enables a souse in the face of such a threat to trigger the equalization scheme absent separation.

Equalization of Net Family Property Upon Death of a Spouse

When a spouse dies, if the net family property of the deceased exceeds the net family property of the surviving spouse, the surviving spouse is entitled to one-half the difference between them.[15] Section 7 of the *FLA* further provides that on the application of a spouse, former spouse or deceased spouse's personal representative, the court may determine any matter respective the surviving spouse's entitlement to an equalization of net family property.[16]

Entitlement to an equalization of net family property is *in personam* as between the spouses, however, an application commenced before a spouse's death may be continued as against the deceased spouse's estate, and an application for an equalization of net family property may be made by or against the deceased spouse's estate, so long as the application is brought after the earliest of:

(a) two years after the day the marriage is terminated by divorce or judgment of nullity;

(b) six years after the day the spouses separate and there is no reasonable prospect that they will resume cohabitation; or

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[12] *Ward v. Ward,* [2012] O.J. No. 3033 (ONCA) at para. 25.
[13] *FLA* at s. 5(3).
[14] *Stone v. Stone,* [1999] O.J. No. 3502 (ONCA) (*"Stone v. Stone"*) at pp. 27.
[15] *FLA* at s. 5(2).
[16] *Ibid* at s. 7.

(c) six months after the spouse's death. [17]

Most importantly however, is section 6 of the *FLA*, which furnishes the surviving spouse with an option to take under the deceased spouse's will (or if the deceased spouse dies intestate, under Part II of the *Succession Law Reform Act*) *or* to elect an equalization of net family property.[18] This availability is significant, as while the surviving spouse can pursue an equalization of net family property after the death of his or her spouse, the relief under section 5(3) of the *FLA* can only be pursued during the lifetime of the spouse.[19]

Fraudulent Conveyances Act

Section 2 of the *Fraudulent Conveyance Act* stipulates as follows:

> "Every conveyance of real property or personal property and every bond, suit, judgment and execution heretofore or hereafter made with intent to defeat, hinder, delay or defraud creditors or others of their just and lawful actions, suits, debts, accounts, damages, penalties or forfeitures are void as against such persons and their assigns..."[20]

Thus, conveyances effected with the malintent indicated in section 2 of the *Fraudulent Conveyances Act* will be deemed invalid, unless pursuant to sections 3 and 4 of the *Fraudulent Conveyances Act*, the transferee can prove that the conveyance was effected for good consideration and in good faith without notice or knowledge of the intent to defeat, hinder, delay or defraud creditors or others.[21] "Creditors or others" has been interpreted by the Supreme Court of Ontario to include judgment creditors, as well as persons who have actions pending against the transferor in which it is clear that they are certain to recover damages.[22]

PART II: The Net Family Property Freeze

One of the most important devices in estate planning is the estate freeze, which allows the future growth of a corporation to devolve, with minimal, if any, immediate tax consequences, to the recipient, while at the same time fixing the donor's wealth.[23]

Martin Rochwerg and M.Y. Berry define an estate freeze as follows:

> "Estate freezing involves the exchange of assets which are growing in value for those which have a fixed value in circumstances where

[17] *Ibid* at s. 7(2).
[18] *Ibid* at s. 6.
[19] Kimberly Whaley and Debra Stephens "Estate Planning & Fraudulent Conveyance: When Does Estate Planning Cross the Line and Become a Fraudulent Preference"(Paper delivered at the B'nai Brith Canada CLE for Lawyers and Accountants: Fraud and Estate Litigation, 4 June 2013) [unpublished] at p. 4.
[20] *Fraudulent Conveyances Act*, R.S.O. 1990, c. F.29 at s. 2.
[21] *Ibid* at s.3 and 4.
[22] *Hopkinson v. Westerman*, [1919] O.J. No. 127 (S.C. ON) at para. 9.
[23] Stephen M. Grant "Estate Freezes in the Family Law Context - The Big Chill Revisited" (2004) 22 C.F.L.Q. 55 ("The Big Chill Revisited") at 55.

> the holder of those assets desires that nay future increase in value of the assets accrues to the benefit of other individuals, usually family members"[24]

The estate freeze initially evolved as a means to avoid the *Gift Tax Act*, which has since been abolished.[25] Prior to the freeze, the donor would typically hold common shares of a business, which shares provide the asset holder with a stake in the profits and direction of company.[26] The donor would essentially "divest" his or her self of the growth of assets by passing that value, in the form of common shares, on to his or her children or some other recipient. In order avoid the gift tax, the growth assets were commonly sold.[27]

Taxation and Benefits of an Estate Freeze

An estate freeze allows an individual to defer capital gains tax on the entire amount of the future increase in the value of the shares, which would otherwise occur as a result of the deemed disposition rule in section 70(5) of the *Income Tax Act*.[28] Section 70(5) of the *Income Tax Act* provides that when a taxpayer dies, he or she is deemed to have disposed of his or her property immediately before death, triggering the realization of any capital gains that have accrued to date.[29]

Martin Rochwerg and Krystle Ng-A-Mann note various other tax benefits to the estate freeze, which include:

- minimizing probate fees;
- enabling family members to become shareholders and to contribute to the future growth of the corporation at minimal cost to them;
- income-splitting opportunities through taking advantage of other family members' lower marginal income tax rates;
- multiplying the use of the lifetime capital gains exemption; and
- providing access to/crystallizing the lifetime capital gains exemption.[30]

An estate freeze therefore presents attractive tax saving opportunities. In addition, there are several non-tax related benefits to implementing a freeze. Depending on the age of the recipient of the shares, the asset holder may not wish to maintain total control to pass with the shares. To

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[24] Martin J. Rochwerg and M.Y. Berry "The Art of Estate Freezing" (Paper delivered at the Osgoode Hall Law School Conference Regarding Legal Issues for the Family Owned Business, 2 and 3 November 1998) [unpublished] at p.1.
[25] The Big Chill Revisited, *supra* note 23 at p. 55.
[26] Lynne Butler, "What is an Estate Freeze", Advisory, 6 January 2010, accessed online: http://estatelawcanada.blogspot.ca/2010/01/what-is-estate-freeze.html.
[27] Robert M. Halpern, *Advising the Family Owned Business*, loose-leaf (consulted on May 2, 2015), (Toronto: Canada Law Book, 1999) ("*Advising the Family Owned Business*") at B6.40(a).
[28] Martin J. Rochwerg and Krystle A. Ng-A-Mann, "Freezing, Thawing and Refreezing: The Intricacies of an Estate Freeze" in *Taxation, Valuation & Investment Strategies in Volatile Markets* (Toronto: Thomson Carswell, 2010) at p. 1-2.
[29] *Ibid* at p. 2.
[30] *Ibid* at p. 2-3.

protect the asset holder's control of the business, the estate freeze may be structured so that only some of the his or her common shares are frozen, or so that the asset holder takes back consideration on the transfer that will allow him or her to participate in future growth.[31] In addition, the asset holder may find security in knowing that he or she has sufficient assets for retirement, safe from the potential deleterious effects of inflation and changing market conditions.[32]

The Net Family Property Freeze

The estate freeze had an unintended negative impact on the recipient, as he or she would be required to include the assets they purchased in their net family property.[33] When growth assets are gifted to a recipient, rather than sold, so as to ensure that the transferred assets are excluded from the recipient's net family property, this effects a net family property estate freeze.[34]

A net family property estate freeze has the double benefit of freezing the donor's assets at the time of the transaction and creating a gift exclusion for the recipient. The process by which an asset holder may effect a net family property estate freeze has been described as follows:

> "The basic net family property freeze involves two companies: (i) the family business; and (ii) a corporation created specifically to effect the freeze. The family business member commences the process by creating a new corporation. This new corporation is usually a holding corporation with its sole asset being the common shares (i.e., the growth shares) of the family business which are purchased from the family business member. The family business member, in exchange for his or her common shares of the family business, is issued preference shares which have the same value as the common shares by virtue of the common shares being the sole asset of the holding corporation. The holding corporation also issues common shares which are gifted to chosen recipients, often the children of the family business member. The result is that future growth of the family business is attributed to the common shares of the holding company while the preference shares are fixed in value. The value of the family business member's interest in the business remains tied at the value of the preference shares."[35]

As noted above, section 4(2) of the *FLA* provides that "property, other than a matrimonial home, that was acquired by gift or inheritance from a third person after the date of marriage" constitutes an exclusion from the net family property calculation. Thus, shares gifted to the recipient as part

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[31] *Ibid* at p. 7.
[32] *Ibid* at p. 8.
[33] *Advising the Family Owned Business*, *supra* note 27 at B6.40(a).
[34] Lorne Wolfson and Rachel Jansen "NFP Freezes – Do They Work?" (Paper presented that the Osgoode Professional Development CLE: Recent Developments and Complex Issues in Property and Equalization, 3 April 2012) [unpublished] ("NFP Freezes") at p. 1.
[35] *Advising the Family Owned Business, supra* note 27 at B6.40(b).

of a net family property estate freeze do not form part of his or her net family property. In order to achieve this exclusion, the common shares of the holding company may be issued to the donor, who would then gift the shares to the recipient. Alternatively, the donor could gift the recipient money to purchase the shares, and pursuant to section 4(2)(e) of the *FLA*, the shares would then be traceable back to a gift from a third party and thus excluded from the recipient's net family property.[36]

The Net Family Property Freeze 'Plus'

Should the asset holder wish to retain the growth in value of the shares, he or she could employ the somewhat riskier net family property freeze "plus". This mechanism combines the net family property estate freeze with a gift back to the asset holder from the recipient, so as to permit the future growth of the shares to accuse to the asset holder, while at the same time constituting excluded property.[37] The process of by which an asset holder may effect a net family property estate freeze plus has been described as follows:

> "Like the net family property estate freeze, the family business member exchanges his or her common shares in the family business for fixed-value preference shares of the holding company. Unlike the net family property freeze, the party who subscribes for the common shares of the holding company, to which all future growth in the value of the family business is attributed, does not retain the shares. Instead, at some later date, perhaps after the marriage of the family business member, the party who holds the common shares of the holding company gifts them to the family business member. The family business member then becomes not only the owner of the present value of the shares of the business in the form of fixed-value preference shares, but also acquires the benefit of any future growth which may arise through the receipt of the gifted (i,e, Part I of the FLA excluded) common shares."[38]

Benefits of the Net Family Property Freeze or Net Family Property Freeze 'Plus'

These methods may have the following benefits to the asset owner in the family law context:

- If the asset owner had an interest in a business before he or she married, then the value of his or her interest in the business may be deducted as at the date of marriage;

- On account of the net family property freeze plus, the asset owner's net family property in respect of the business will be frozen at the value of the preference shares;

[36] *FLA, supra* note 4 at s. 4(2) and *ibid* at B6.40(b).
[37] *Advising the Family Owned Business, supra* note 27 at B6.40(c).
[38] *Ibid.*

- The asset owner will be able to exclude the value of the common shares gifted to him or her during the marriage and any increase in value of the common shares, on account of the net family property freeze plus.[39]

- If the asset owner implements the net family property freeze before he or she is married, then the full value of the preference shares is deducted from the asset owner's net family property as at the date of marriage and the value of the common shares received after marriage is excluded from his or her net family property on the basis that it is a gift from a third party.[40]

Family Law Implications of the Net Family Property Freeze or Net Family Property Freeze 'Plus'

Courts have struggled with the classification of assets acquired through net family property freezes as gifts, as the prevailing philosophy behind excluding a gift from net family property is that gifts are "gratuitous transfers from third parties and as such are unrelated to the partnership or joint efforts of the parties".[41] The problem with estate freezes and net family property freezes is that although they may appear to be a gift, the larger family corporate or tax purposes seem to make the courts reluctant to allow exclusions because this is not the type of exclusion that was initially contemplated by the *Family Law Act*, given that freezes are structured so as to take an asset which would likely not be excluded property and turn it into a gift.[42] It should be noted, however, that the FLA itself does not have any provisions explicitly dealing with a freeze.[43]

Prior to the decision in *McNamee v. McNamee*,[44] the judicial treatment as to whether assets acquired from a net family property freeze are proper exclusions was inconsistent, resulting in the courts' reluctance to permit gifts in the context of an estate freeze.[45]

In *McNamee v. McNamee* the parties shared everything during the marriage equally. The husband's father transferred 500 common shares in his company to the husband as part of an estate freeze. Unbeknownst to the husband, the father executed a Declaration of Gift which provided that neither the shares nor any increase in their value of income from them were to form part of the husband's net family property in the event of a breakdown of the husband's relationship, and that the shares were to remain the husband's property, free from control by the wife. Accordingly, at trial, the husband claimed that the shares were a gift and therefore constituted an exclusion from his net family property.

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[39] *Ibid.*
[40] *Ibid.*
[41] NFP Freezes, *supra* note 34 at p. 3.
[42] *Ibid.*
[43] Timothy Youdan "Trust Issues" (Paper presented at Law Society of Upper Canada, Third Annual Family Law Summit, 11-12 June 2009) at p. 20.
[44] *McNamee v. McNamee*, 2011 ONCA 533 ("*McNamee v. McNamee*").
[45] See *Karakatsanis v. Georgious*, [1991] O.J. No. 1298, and *Dalgleish v. Dalgleish*, [2003] O.J. No. 2918 (Ont. S.C.J.) where shares acquired by subscription for nominal consideration were not deemed exclusions from net family property. See also *Jensen v. Jensen*, [1994] B.C.J. No. 2603, where the court, in considering the intention of the gift (despite nominal consideration) permitted the exclusion. See also *Armstrong v. Armstrong*,[2003] O.J. No. 1429, where no consideration was paid and the interest on the freeze assets was excluded.

The wife advanced a claim for a beneficial ownership interest in the shares on the basis of unjust enrichment or constructive trust. The trial judge found that the transfer of shares to the husband was not a gift, therefore rendering those shares subject to an equalization of net family property, because:

(a) the transfer was for consideration;

(b) the father did not intend to gift the shares;

(c) the father did not divest himself of all power or control over the shares; and

(d) the husband did not accept the gift.

The husband appealed successfully. The Court of Appeal for Ontario held that the husband's intention was to transfer the shares gratuitously; and that the estate freeze was the ultimate motivation or purpose. The fact that the husband could affect the value of the shares due to the nature of the estate freeze had no bearing on whether the shares were transferred as a gift.

The Court of Appeal held as follows:

> "…we are satisfied that the Appellant received his 500 common shares in the company as a gift. Subject to the constructive trust/unjust enrichment analysis…it follows that, by operation of s. 4(2) of the *Family Law Act*, neither the Appellant's ownership interest in the shares, nor any increase in the shares' value, form part of the appellant's net family property for the purposes of calculating the equalization payment."[46]

While the *McNamee v. McNamee* decision clarifies that shares acquired through an estate freeze is a gift (so long as the transfer is gratuitous) which may be excluded for family law purposes, as noted by Lorne Wolfson and Rachel Jansen in "NFP Freezes: Do they Work?", it leaves unresolved the question of whether or not a purchase of shares for nominal consideration still constitutes a "gift" eligible for exclusion, rather than a "purchase".[47]

There also remains the risk that the freeze may be overturned on the basis that it is a fraudulent conveyance. This was addressed by the Court of Appeal for Ontario in *Reisman v. Reisman*.[48] In this case, the parties separated 2006 after a traditional marriage of 20 years. One of the main issues arising from their separation was whether an estate freeze undertaken by the husband's father in 1998 amounted to a fraudulent conveyance. The trial judge ruled in favour of the husband, dismissing the wife's claim that the estate freeze was a fraudulent conveyance. The wife appealed and her appeal was dismissed on the basis that she was not entitled to set aside the conveyance under the *Fraudulent Conveyances Act*, as given that the parties were still married at the time of the conveyance and thus she had no claim for an equalization payment, she was not at that time a creditor of the husband.

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[46] *McNamee v. McNamee, supra* note 44 at para. 53.
[47] "NFP Freezes", *supra* note 34 at 12.
[48] *Reisman v. Reisman*, 2014 ONCA 109.

PART III: The Alter Ego and Joint Partner Trust

Typically, Canadians have used a will to distribute assets owned at the date of death. However, where an individual uses a will as part of his or her estate planning strategy, an estate administration tax (colloquially referred to as "probate") will be applied upon the death of the testator if the will encompasses assets in excess of $1,000.00.[49] Under the *Estates Administration Act*, when an individual dies testate and property is passed under the will, an estate administration tax must be applied and paid for the value of the estate, which includes property that belonged to the deceased person at the time of his or her death less the actual value of any encumbrance on real property that is included in the property of the deceased person.[50] It should be noted that there is no federal probate levied, and as such, multiple probate proceedings may be required where real property is owned in multiple Canadian jurisdictions.[51]

The amount of tax payable where the estate probate application is made after June 7, 1992 is:

(a) five dollars for each $1,000 or part thereof of the first $50,000 of the value of the estate; and

(b) fifteen dollars for each $1,000 or part thereof by which the value of the estate exceeds $50,000.[52]

When considering estate planning options, a settlor or testator (creator of a will) may choose from a variety of will substitutes which devolve directly to a named beneficiary, and thus do not form part of the deceased's estate, thereby avoiding probate. The establishment of a trust is a common method employed in Canadian estate planning and as will be discussed later on, carry numerous tax and non-tax advantages over the typical will.

A trust is a relationship wherein a person (the settlor), transfers property to another person (the trustee), who holds that property for the benefit of another person (the beneficiary).[53] The law does not recognize a trust as a legal entity, rather, a trust is the relationship between persons relative to property held under the relationship.[54]

There are two types of personal trusts: testamentary trusts and *inter vivos* trusts. Testamentary trusts are typically established under the will of the settlor, usually for the benefit of the deceased settlor's family members, which may include a spouse, descendants, or both.[55] *Inter vivos* trusts are established by the settlor during his or her lifetime, often for the benefit of a spouse, children

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[49] *Estates Administration Act,* R.S.O. 1990, c. E.22 ATA s. 2(2) ("*EAA*").
[50] *Ibid* at s.1(1) "value of estate".
[51] Martin J. Rochwerg and Leela A. Hemmings "Trusts, Trustees, Trusteeships III: Use of Trusts as Will Substitutes" (Paper, 23 September 2008), [unpublished] ("Trusts, Trustees, Trusteeships") at p. 2.
[52] *EAA, supra* note 49 at s. 2(6).
[53] Larry H. Frostiak, John Poyser and Grace Chow, *Taxation of Trusts and Estates* (Toronto: Thomson Carswell, 2008) ("*Taxation of Trusts and Estates*") at p. 3.
[54] *Ibid* at p. 3.
[55] Martin J. Rochweg "Recent Developments in Estate Planning: The Alberta Advantage When Using Trusts" (Paper, 1 December 2004) [unpublished] ("Recent Developments in Estate Planning") at p. 2.

or other family members.[56] Section 108(1) of the *Income Tax Act* defines a testamentary trust as a trust “that arose on and as a consequence of the death of an individual” with certain exceptions.[57] An *inter vivos* trust is defined by the *Income Tax Act* as “a trust other than a testamentary trust."[58]

In 2001, broad changes to the *Income Tax Act* introduced several new *inter vivos* trusts for consideration by the estate planner[59]. Of particular concern to the elderly client, are the alter ego trust and the joint spousal or common law partner trust (the “joint partner trust”). Alter ego trusts and joint partner trusts are specific *inter vivos* trusts, to which individuals 65 years or older may transfer assets on a tax-deferred basis.[60] Unlike traditional *inter vivos* trusts, the alter ego and joint partner trusts permit the settlor(s) to transfer assets to the trust without triggering tax on accrued gains on the assets, as will be discussed in greater detail below. The settlor(s) have the benefit of being the only person(s) entitled to the trust property, but once the property of the trust is settled, it is no longer under the control of the settlor(s), and therefore excluded from the settlors’ estate(s), or arguable, the settlor(s)’ net family property.

The Alter Ego Trust

The alter ego trust is defined in section 248(1) as “a trust to which paragraph 104(4)(*a*) would apply if that paragraph were read without reference to subparagraph 104(4)(*a*)(iii) and clauses 104(4)(*a*)(iv)(B) and (C)”.[61] Pursuant to sections 73(1), (1.01) and (1.02) of the *Income Tax Act*, in order for a trust to constitute an alter ego trust, it must have the following characteristics:

- the settlor must be at least <u>65 years of age</u>;
- the trust is created during the settlor’s lifetime;
- the trust is created after 1999;
- the settler and the trust must both be resident in Canada;
- the settler is entitled to receive all of the income of the trust arising before his or her death;
- no person except the settlor is entitled to receive or otherwise obtain the use of any of the income or capital of the trust before the settlor’s death (note that there is no requirement that the settlor have any entitlement to the capital); and

[56] *Ibid* at p. 2.
[57] *Income Tax Act*, R.S.C., 1985, c. 1 (5th Supp.) (“*ITA*”) at s. 108(1).
[58] *Ibid* at s. 108(1).
[59] Tabled in the June 2000 Notice of Ways and Means Motion and re-Tabled on March 16, 2001 Notice of Ways and Means Motion, receiving Royal Assent on June 2001 pursuant to S.C. 2000 c.17
[60] O’Sullivan Estate Lawyers “Advisory: Alter Ego and Joint Partner Trusts”, Advisory, online: http://www.osullivanlaw.com/Advisory-Letters/Alter-Ego-and-Joint-Partner-Trusts.pdf (“O’Sullivan Advisory”)
[61] *ITA*, *supra* note 57 at s. 248(1).

- the trust must not elect out of section 104(4) of the *Income Tax Act* which deems the trust to dispose of its assets upon the death of the settlor (if the trust does make this election after any assets are transferred into the trust, then no rollover will be available on the transfer of the assets into the trust and the first deemed disposition of the trust will occur 21 years after the establishment of the trust and every 21 years thereafter.[62]

The Joint Partner Trust

The joint partner trust is defined in section 248(1) of the *Income Tax Act* as "a trust to which paragraph 104(4)(*a*) would apply if that paragraph were read without reference to subparagraph 104(4)(*a*)(iii) and clause 104(4)(*a*)(iv)(A)".[63] Similar to alter-ego trusts and also pursuant to sections 73(1),(1.01) and (1.02) of the *Income Tax Act*, joint-partner trust must have the following characteristics:

- the settlor must be at least <u>65 years of age</u>;
- the trust is created during the settlor's lifetime;
- the trust is created after 1999;
- the settlor and the trust must be resident in Canada;
- the settlor and the settlor's spouse or common law partner, in combination with each other, must be entitled to all of the income of the trust that arises before the death of the survivor of them;
- before the death of the survivor of the settlor and the settlor's spouse or common law partner, it must not be possible for any person, other than the two of them to receive or otherwise obtain the use of any of the income or capital of the trust; and
- the trust must not elect out of subsection 104(4) of the *Income Tax Act* which deems the trust to dispose of its assets upon the death of the survivor of the settlor and the settlor's spouse.[64]

Taxation and Benefits of Alter Ego and Joint Partner Trusts

Alter ego and joint partner trusts are taxed as other inter *vivos trusts*: at the top marginal rate applicable to individuals. Income of the trust must be paid to the settlor(s) and tax on trust

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[62] M.E. Hoffstein and Lee-Anne Armstrong "Alter Ego Trusts and Joint Partner Trusts – Tips and Traps" (Paper, 1 November 2002) [unpublished] ("Alter Ego Trusts and Joint Partner Trusts") at p. 2-3 and Maurice Cullity et al, *Taxation and Estate Planning*, loose-leaf (consulted on 15 May 2015), (Toronto: Carswell, 2006) ("*Taxation and Estate Planning*") at 3.2.60.20.

[63] *ITA*, *supra* note 57 at s. 248(1).

[64] Alter Ego Trusts and Joint Partner Trusts, *supra* note 62 at p.3 and *Taxation and Estate Planning*, *supra* note 62 at 3.2.60.30.

income is paid by the settlor(s) at his, her or their respective graduated rates of tax unless a special tax election is made to tax the income in the trust.[65] Thus, alter ego and joint partner trusts do not have the benefit of graduated tax rates, as would a testamentary trust.[66]

In addition, attribution rules may apply to alter ego and joint partner trusts. In the case of alter ego trusts, income splitting is not possible during the settlor's lifetime because all of the income of the trust must be payable to the settlor and no person may receive or otherwise obtain the use of the capital of the trust during the settlor lifetime.[67]

There are other specific tax disadvantages to the use of an alter ego and joint partner trust, including:

- RRSPs and RRIFs cannot be transferred to an alter ego or joint partner trust;
- if legal title to land is being transferred, property transfer tax has to be considered;
- an alter ego or joint partner trust cannot benefit from the $750,000 capital gains exemption for shares held in a qualified small business corporation or qualified farm or fishing property;
- the farm/fishing property rollover to certain family members is not applicable from an alter ego or joint partner trust;
- there is a deemed disposition of assets on the death of a settlor of an alter ego trust, but there is no rollover allowed to a spouse or common law partner; and
- a gift to a charity following the death of the settlor of an alter ego trust does not qualify as a gift by will under section 118.1(5) of the *Income Tax Act*.[68]

The primary tax advantage of using an alter ego or a joint partner trust is that transfers of property may be made on a tax-deferred basis, pursuant to section 73(1) of the *Income Tax Act.* Otherwise, transfers to such trusts would constitute a disposition and be deemed to occur for proceeds equal to fair market value because the transferor and the transferee are not dealing at arm's length.[69] Therefore, the settlor may roll property into the trust and defer the realization of a capital gain on such property until his or her death or the death of his or her spouse or common law partner. There is no rollover available for property that is not capital property.[70]

Also, there is no deemed disposition of property of the trust on the 21st anniversary of the establishment of an alter ego or joint partner trust, unless an individual makes an election under

[65] O'Sullivan Advisory, *supra* note 60.
[66] *Taxation and Estate Planning, supra* note 62 at 3.20.60.60.10.
[67] Recent Developments in Estate Planning, *supra* note 55 at p. 6.
[68] *Taxation and Estate Planning, supra* note 60 at 3.20.60.60.40.
[69] Recent Developments in Estate Planning, *supra* note 55 at p. 5.
[70] *Taxation and Estate Planning, supra* note 69 at 3.20.60.50.10.

section 104(1)(a)(ii.I) of the *Income Tax Act*. Rather, there is a deemed disposition of property on the death of the settlor, in the case of an alter ego trust, or on the death of the survivor of the settlor and the settlor's spouse/partner, for the joint partner trust.[71] However, it is possible for an individual to elect under section 104(I)(a)(ii.1) of the *Income Tax Act* not to have the rollover apply when capital property is put into the trust. Where this election is made, the first deemed disposition of property under section 104(4) will occur on the 21st anniversary of the establishment of the trust and not on the death of the settlor or the death of the survivor of the settlor's spouse/partner, as applicable.[72]

As noted by Catherine Brown in "Alter Ego, Joint Conjugal & Self-Benefit Trusts Revisited", common non-tax reasons for establishing an alter ego or joint partner trust include:

- potential probate savings, as noted above;
- confidentiality;
- centralization of property and continuity of management;
- asset management without using a power of attorney;
- protection from creditors; and
- protection from spousal claims under legislation such as the *Family Law Act* or the *Succession Law Reform Act*.[73]

The latter benefit is of course the most pertinent to our present purpose and will be discussed in detail in the following section.

Family Law Implications of the Use of Alter Ego or Joint Partner Trusts

As established in Part I, an individual's net family property includes any growth in the value of assets after the date of marriage to the date of a breakdown in the relationship, subject to the creation of an exclusion. By conveying assets to a trust, an individual may reduce his or her net family property.[74]

The circumstances of the transfer, however, may evoke judicial scrutiny on the basis that such a transfer was intended to undermine the transferor's obligations under the *FLA*, and thus the effect of the trust could be negated by a spouse's application for an unequal division of net family property or a an application brought on the basis that the settlor has intended to improvidently deplete his or her net family property prior to separation.[75]

Further caution should be had in doing so when the named beneficiary of the alter ego or joint partner trust is the settlor(s)' child, as notes Robert M. Halpern in *Advising the Family Owned Business*: "A drawback of the trust, where it is made in favour of the children, is that their

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[71] *Ibid* at 3.20.60.50.20.
[72] *Ibid* at 3.20.60.50.30.
[73] Catherine Brown "Alter Ego, Joint Conjugal, and Self-Benefit Trusts Revisited: Some Troubling Tax Issues and A Search for Better Alternatives" (2005) 24 Estates, Trusts & Pensions Journal 346 at 347.
[74] *Advising the Family Owned Business, supra* note 27 at B6.30.
[75] Alter Ego Trusts and Joint Partner Trusts, *supra* note 62 at p. 40.

interest in the trust will constitute property for the purposes of their net family properties."[76] In addition, the Court of Appeal for Ontario held that the *FLA* does not exclude other applicable statutory or common law remedies which deal with the ownership of property, including the *Fraudulent Conveyances Act*.[77]

In *Black v. Black*, the courts determined that an even a contingent interest in a discretionary trust is property under the *FLA*.[78] It is therefore imperative to be cognizant of timing and be clear as to the intention in establishing an alter ego or joint partner trust, lest the court decide that it is properly included in net family property on the basis that the establishment of a trust was a fraudulent conveyance, or it was intended to deplete net family property so as to avoid an individual's family law obligations.

PART IV: PRACTICE TIPS

Before implementing a net family property freeze or settling an alter ego or joint partner trust, counsel should advise their client to consider the following:

- Is the goal of the freeze/trust to minimize your own net family property?[79]
- Is the goal of the freeze/trust to structure the transfer by way of a gift to create an exclusion for the beneficiary for *FLA* purposes?[80]
- In the context of a freeze, is there enough accrued value in the shares to justify a freeze?[81] Is there enough for the parents' retirement?[82]
- In the context of a trust, the cost of establishing and maintaining the trust may be greater than the advantage in doing so, from a probate savings perspective and a family law perspective.
- Is the client comfortable relinquishing control over the assets?
- Is this the right time to be transferring assets? If the transaction occurs during the marriage at a time when the marriage is strained, this may make it easier to challenge.[83]
- If the client effecting the estate freeze is married, fairness, *bona fides* and disclosure should be extended to the spouse. The client should also consider involving the spouse in the freeze.[84]

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[76] *Advising the Family Owned Business, supra* note 27 at B6.30.
[77] *Stone v. Stone, supra* note 14.
[78] *Black v. Black*, [1988] O.J. No. 1975 (Ont. H.C.).
[79] *Advising the Family Owned Business*, *supra* note 27 at B6.40(e).
[80] *Advising the Family Owned Business*, *supra* note 27 at B6.40(e).
[81] Robert C. Dunseith, "Estate Freezes: What, Why, When and How" (Paper presented to the Legal Education Society of Alberta, Advising a Private Family Business, 27 November 2012 and 4 December 2012) at p. 5.
[82] *Ibid.*
[83] "NFP Freezes", *supra* note 34 at p. 12.
[84] *Ibid* .

- If the recipient in an estate freeze is not yet married or cohabiting, a marriage contract should be prepared.

Once the client has decided to implement an estate freeze or settle an alter ego or joint partner trust, and has established his or her objectives in doing so, carefully document the transaction:

- The Deed of Trust should be carefully drafted to meet the client's family law objectives;

- A formal declaration of gift should be signed by both the donor and the recipient containing an acknowledgment of the terms of the gift as well as its receipt.[85]

- Do not prepare a promissory note as a form of payment for the transfer of shares, as this creates consideration which defeats the argument of gift, and forgiveness of debt in the family law contest to do not constitute a gift.[86]

- As noted by Lorne Wolfson, in the context of a net family property freeze, "if the business is private, the shareholders agreement should set out the events which trigger a buy-out and how that buy-out is to be funded. The shareholder agreement should also set out a valuation method for the shares to be both out. It is suggested that a valuation method which best approximates fair market value be chosen."[87]

Another practical consideration is that of 'the client'. A client may require that a power of attorney or guardian be appointed to ensure that his or her affairs are managed properly in the event that they are incapable of or unable to do so personally. As noted by M. Elena Hoffstein:

> "A general unrestricted power of attorney can make the simple statement that the attorney can do on behalf of the principal or incapable principal anything such principal could do if capable. Thus, an attorney could buy, sell, invest and otherwise deal with the property of the principal".[88]

A power of attorney or guardian could therefore implement a net family property freeze or settle an alter ego or joint partner trust (assuming the qualifications are otherwise met). So doing may have effect of depleting the incapable principal's net family property, leaving that individual at risk to a claim attacking the transfer, or an application seeking an unequal division of net family property or an equalization of net family property on the basis of improvident depletion, by the incapable principal's spouse. As such, care must be taken in drafting a power of attorney, and powers of attorney or guardians must be cognizant of the family law implications when acting on behalf of an incapable principal. Counsel should:

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[85] *Ibid.*
[86] *Ibid.*
[87] Lorne Wolfson "The Family Law Act: how Planning For it May Ruin your Marriage While Not Planning For It May Ruin Your Company" (1989) 4 CFLQ 223.
[88] M. Elena Hoffstein, "Family Law and Estates, Trustee and Guardianship Issues" (Paper, presented to the Family Law Summit: A Multidisciplinary Perspective, 11 May 2007) at p. 4.

- Identify whose interests they are retained to protect;
- Identify the impact of the estate freeze or trust on:
    - the recipient/beneficiary's net family property; or
    - if there is a spouse, the spouse's net family property
- Ensure that all parties affected by an estate freeze or trust obtain independent legal advice.