

Tax Effective Cross-Border Will Planning

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AGENDA

1. Introduction
2. U.S. Gift, Estate and Generation-Skipping Taxes
3. Tax Effective Strategies with U.S. Persons
4. Canadian Tax Consequences of Non-Resident Trusts and Beneficiaries
5. Canadian Wills and U.S. Beneficiaries
6. Conclusion

Introduction

- The U.S. taxes transfers of property, often without consideration for a person's residence
 - Estate tax – payable by the deceased's estate upon his or her death
 - Gift tax – payable during a person's lifetime with respect to transfers of property
 - Generation-skipping tax – taxes transfer to successive generations
- U.S. citizens are required to file annual U.S. tax returns and may be liable for the payment of U.S. taxes upon death
- Canadian tax laws give rise to added complications when U.S. residents are beneficiaries or trustees of trusts
- All of these issues need to be carefully considered when drafting Canadian Wills that involve U.S.-*situs* property, or U.S. trustees or beneficiaries
- Specific language and key concepts may help make Canadian Wills more tax-efficient, on both sides of the border

U.S. Gift, Estate and Generation-Skipping Taxes

- U.S. Estate Tax
 - *IRC Code and Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010*
 - Statutes that deals with estate tax, gift tax and generation-skipping tax
 - Applies on the death of individuals who are:
 - “U.S. persons”; and
 - Non-“U.S. persons” who own U.S.-*situs* property (to the extent of the U.S.-*situs* property holdings)
 - U.S.-*situs* property includes:
 - Real estate owned by an individual in the U.S.
 - Shares that are listed and traded on a registered U.S. stock exchange. These shares may be owned outright, or they could be owned by an individual's Canadian RRSP

- U.S. Estate Tax (continued)
 - “U.S. person” includes:
 - U.S. citizens
 - People born in the U.S. who keep their citizenship
 - People who become naturalized in the U.S. as citizens
 - Dual citizens who were born in the U.S. and might not realize that they are U.S. citizens
 - U.S. residents
 - “Substantial presence” test
 - » Subject to the “closer connection” exception
 - Tax treaty rules—”centre of vital interest” test
 - U.S. domiciled individuals
 - Show an “intent to remain” in the U.S. (includes green card holders)

- U.S. Estate Tax (continued)
 - The future of the estate tax regime is uncertain
 - This is likely going to be an election issue in the 2012 U.S. presidential election
 - Estate tax exemption for 2011-2012 is \$5,000,000
 - For deaths occurring during this period, the first \$5,000,000 of a deceased's "gross estate" is received tax-free
 - "Gross estate" – the value of all of the deceased's property, real or personal, tangible or intangible, wherever situated. Includes property in which the deceased had a beneficial interest, life insurance policies owned by the deceased in the 3 years prior to death, property in respect of which the deceased had a power of appointment and any gift taxes paid on gifts made within 3 years of the deceased's death
 - Highest estate tax rate for 2011-2012 is 35%
 - This rate applies on the value of an estate above and beyond the \$5,000,000 exemption

- U.S. Estate Tax (continued)
 - Jointly owned property
 - Depends on whether the property is jointly owned with the deceased's U.S. citizen spouse, or whether the spouse is a non-citizen
 - If the property is held jointly with a U.S.-citizen spouse, then $\frac{1}{2}$ of the value of the property is included in the determination of the deceased's "gross estate" for estate tax purposes
 - If the property is held jointly with a non-citizen spouse, 100% of the value of the property is included within the determination of the value of the deceased's "gross estate" for estate tax purposes

- U.S. Estate Tax (continued)
 - Jointly Owned Property (continued)
 - 2 Exceptions to the latter rule
 - (1) The surviving spouse becomes a U.S. citizen before the deceased's terminal income tax return is due; or
 - (2) Property passing to the surviving spouse is transferred to a qualified domestic trust (QDOT)
 - Unlimited Marital Deduction
 - Permits the deferral of U.S. estate tax with respect to property that passes to a spouse
 - Property may pass directly to the spouse, or be placed in a qualified interest property trust (QTIP) for the spouse's benefit
 - Unlimited marital deduction is not available in respect of a spouse who is not a U.S. citizen

- U.S. Gift Tax

- For 2011-2012, similar to estate tax, subject to a 35% rate and \$5,000,000 exemption
- Applies to all gratuitous transfers of property made by a U.S. person, either direct or indirect, in trust or otherwise
- Tax liability imposed on the donor
- Reporting obligations extend to the donee
- For gifts made to non-U.S. citizens, the gift tax applies only to the extent that gifted property is situated in the U.S.

- U.S. Gift Tax (continued)

- Unlimited Marital Deduction

- Similar to the estate tax regime, an unlimited marital deduction is available to the extent that gifts are made to a spouse who is a U.S. citizen
 - If the spouse to whom a gift is made is not a U.S. citizen at the time the gift is made to him or her, the deduction is not available

- Annual Exclusion

- An annual exclusion of \$112,000 is available on gifts that are made by a U.S. citizen spouse to a non-citizen
 - These gifts must be made to the non-citizen spouse during the U.S. citizen donor's lifetime

- U.S. Generation-Skipping Transfer Tax (GSTT)
 - Imposed in addition to the estate or gift tax at a rate of 35%
 - Applies to gratuitous transfers made to a donee who is two or more generations below the donor (i.e., gift from a grandparent to a grandchild that “skips” a generation)
 - There is a \$1,100,000 GSTT exemption available during a donor’s lifetime
 - GSTT only applies to real or tangible property that has a U.S.-*situs*
 - Stock in a U.S. company is an intangible and, to the extent that it is transferred by a non-U.S. citizen or resident, GSTT does not apply to the transfer

Tax Effective Strategies with U.S. Persons

- U.S. Citizen Spouses Living in Canada
 - Gifts made during the spouses lives can help take advantage of annual exemption limits to U.S. gift tax and could help equalize an estate between spouses
 - Testamentary spousal trusts
 - Qualify as “by-pass trusts” or “credit shelter trusts” for U.S. tax purposes
 - Trust would be a qualifying spousal trust for the purposes of the *Income Tax Act* (Canada) (i.e., only the spouse has access to the income and/or capital of the trust during his or her lifetime)

- U.S. Citizen Spouses Living in Canada (continued)

- Testamentary Spousal Trusts (continued)

- As a qualifying spousal trust, there are two advantages for Canadian tax purposes:
 - A tax-free rollover with respect to capital property that is transferred into the spousal trust upon the first spouse's death; and
 - An exclusion to the 21-Year Deemed disposition rule.
 - The spousal trust is funded up to the exclusion amount with respect to estate and/or gift taxes (currently \$5,000,000) (this is particularly advantageous when the spouses have wealth in excess of the exclusion amount)
 - Property passing to the trust, for U.S. purposes, is not subject to the marital deduction, but unified credits are still available to fully offset any tax liability on the first to die

- U.S. Citizen Spouses Living in Canada (continued)
 - Irrevocable Life Insurance Trust
 - Life insurance proceeds flow into the trust on a tax-free basis for Canadian tax purposes
 - Life insurance proceeds, however, form part of U.S. persons' "gross estate" for U.S. estate tax purposes
 - The irrevocable life insurance trust is established as the owner of the life insurance policy and not the spouses, so estate tax liability is avoided
 - However, the initial transfer of the life insurance policy to the trust may constitute a taxable trust if the transferor survives the transfer by at least 3 years

- U.S. Citizen Spouses Living in Canada (continued)

- QTIPs

- Also referred to as a “marital deduction” trust, since the property that is transferred to this trust will qualify for the marital deduction
- Provides for the surviving spouse, with an ultimate transfer at the end to the children of the marriage
- Well suited for second-marriage situations, where a spouse would like to ensure that the other spouse is taken care of during his or her lifetime, but that provision is also made for his or her children
- Similar to Canadian spousal trusts, during his or her lifetime, the surviving spouse must be the only beneficiary of the trust during his or her lifetime

- U.S. Citizen Spouses Living in Canada
(continued)

- QTIPs (continued)

- Income from the trust must be paid out at least once a year to the surviving spouse
- Accordingly, the QTIP may also be a qualifying spousal trust for Canadian tax purposes
 - Transfers of property into the QTIP may therefore take place on a tax-free basis upon the death of the first spouse
- QTIPs may also be useful in situations where it may be likely that a spouse will remarry following the death of the first spouse

- U.S. Citizen Spouses Living in Canada (continued)
 - If the spouses have children, they may also consider including generation-skipping trusts for their children in their Wills
 - They may thus utilize their exemptions with respect to GSTT

- U.S. Citizen Spouse Married to a Non-Citizen in Canada

- Problem:

- U.S. citizen spouse, as a “U.S. person,” is subject to estate tax on his or her “gross estate”
- Because the U.S. citizen is married to a non-citizen, he or she cannot take advantage of the unlimited marital deduction upon his or her death with respect to U.S. estate and gift tax liability
- The U.S. citizen likely owns property jointly with his or her spouse that will be subject to U.S. estate tax, since the non-citizen does not count as a joint owner for U.S. estate tax purposes

- U.S. Citizen Spouse Married to a Non-Citizen in Canada (continued)
 - Lifetime gifting
 - If the U.S. citizen spouse wants to minimize his or her potential estate tax liability by equalizing an estate, may want to make annual gifts to the spouse in order to take advantage of the annual gifting exemption
 - Gifts should be well documented with deeds of gift to ensure that the gratuitous transfer of property is recorded
 - For Canadian tax purposes, the gift from one spouse to the other will generally be tax-free, subject to any potential capital gains tax liability

- U.S. Citizen Spouse Married to a Non-Citizen in Canada (continued)
 - Spousal Trust
 - Transfer to the spousal trust proceeds on a tax-free basis for Canadian tax purposes if the U.S. citizen spouse is the first to die
 - Spousal trust is a U.S. bypass trust for U.S. tax purposes
 - The spousal trust will be funded with the \$5,000,000 estate tax exemption
 - U.S. citizen spouse will be able to apply any available tax credits with respect to the tax liability generated upon death, if any, as a result of the transfer to the spousal trust

- U.S. Citizen Spouse Married to a Non-Citizen in Canada (continued)
 - QDOT
 - Excess over the \$5,000,000 exemption may be allocated to a QDOT that is created on a testamentary basis in the U.S. citizen's Canadian Will
 - For Canadian tax purposes, the QDOT will qualify as a testamentary spousal trust, with the trust property vesting indefeasibly with the surviving spouse within 36 months of death
 - During his or her lifetime, the surviving spouse will be the only person entitled to the income and/or capital of the QDOT

- U.S. Citizen Spouse Married to a Non-Citizen in Canada (continued)
 - QDOT (continued)
 - To qualify as a QDOT, 7 requirements must be met:
 - (1) the property passing from the deceased to the QDOT must be included in the surviving spouse's estate for U.S. tax purposes
 - (2) at least one of the trustees must be a U.S. citizen or domestic corporation (if assets are substantial, a U.S. bank must act as trustee and a bond may need to be furnished to the IRS as security)
 - (3) no principal may be distributed to the spouse; only the income from the assets in the QDOT;

- U.S. Citizen Spouse Married to a Non-Citizen in Canada (continued)

- QDOT (continued)

- To qualify as a QDOT, 7 requirements must be met (continued):
 - (4) all of the trust income must be paid to the spouse on an annual basis;
 - (5) QDOT election must be made on the deceased's terminal income tax return;
 - (6) QDOT must comply with U.S. regulations; and
 - (7) if the QDOT assets are over \$2,000,000, no more than 35% of the assets' FMV may be invested in real estate located outside of the U.S.

- U.S. Citizen Spouse Married to a Non-Citizen in Canada (continued)
 - One common U.S. strategy is for the U.S. citizen to make an outright gift, by Will, to the non-citizen spouse
 - The spouse should have the option to disclaim part or all of the outright gift
 - If the spouse disclaims the gift, then the property will pass to a QDOT for the spouse's benefit during her lifetime
 - Strategy may expose assets to Canadian and U.S. tax liability upon death, however
 - Spouse may become a U.S. citizen in the intervening period and be able to claim the marital deduction in respect of U.S. gift and/or estate taxes
 - Spouse may actually want to pay the taxes

- U.S. Citizen Spouse Married to a Non-Citizen in Canada (continued)
 - If the non-citizen is the first to die, a Canadian testamentary spousal trust may still be established for the benefit of the surviving U.S. citizen spouse
 - Funded with the estate tax exemption amount
 - Qualifies as a U.S. bypass trust
 - If the spouses have children, since one parent is a U.S. citizen
 - Testamentary family trusts may be created that will also qualify as U.S. bypass trusts
 - Separate trusts may be created for each child
 - A single trust may be established for the children from the QDOT, until the youngest child reaches a given age, and then separate trusts for children until any age

Canadian Tax Consequences of Non-Resident Trusts and Beneficiaries

- General rule of thumb: trusts are resident in the jurisdiction in which the trustees are resident
- *Garron Family Trust* (2010 FCA): Upheld the Tax Court of Canada's decision that the central place of management test applies to the determination of the residence of a trust
 - Trustees were resident in Barbados, but the trusts were held to be resident in Canada, since that was the place of central management
 - Trustee in the case was a professional “straw man” with little actual decision-making power in respect of the trust property

- Non-resident trusts may be deemed to be resident in Canada by operation of s. 94(3) of the *Income Tax Act*
 - A trust will be subject to tax for a taxation year as a trust resident in Canada if a contribution was made to the trust by a “resident contributor” and if the trust has a “resident beneficiary”
 - “Resident contributor” (s. 94(1) of the ITA): an entity resident in Canada and a contributor to the non-resident trust
 - Contributor – an entity that at or before a time has made a contribution (includes any transfer or loan, other than an arm’s length transfer)
 - Status terminates on death or dissolution
 - “Resident beneficiary” (s. 94(1) of the ITA): beneficiary of a non-resident trust who is a Canadian resident at any time and there is a “connected contributor” to the trust

- Non-Resident Trusts and s. 94 (continued)
 - “Connected contributor” (s. 94(1) of the ITA):
generally, a contributor to a trust at a particular time, who, in the 60-month period prior to making a contribution to the trust, was a Canadian resident
 - Proposed amendments to s. 94 propose a two-part test for determining whether the trust is resident in Canada:
 - (1) Is there a resident beneficiary?; and
 - (2) Is there a connected contributor?

- Non-Resident Trusts and s. 94 (continued)
 - New rules have been criticized as unworkable, broad and unnecessarily complex
 - Non-resident trusts will only be taxable on income attributable to property acquired by the trust from Canadian residents and Canadian source income.
 - The trust is responsible for the Canadian tax liability. Otherwise, the resident contributor and/or resident beneficiary are jointly and severally liable for the tax liability
 - All other Canadian tax rules apply as though the trust was resident in Canada if it falls prey to s. 94(3)

- One or more of the common law place of central management and control test and s. 94(3) of the *Income Tax Act* may cause a trust to be deemed resident in Canada
 - However, benefits under the Canada-U.S. Income Tax Treaty may be available if the trust is deemed resident in Canada
- Planning challenges:
 - No ability to deduct income distributed to beneficiaries under s. 104(6) of the *Income Tax Act* if the beneficiaries are non-residents (Part XIII withholding tax will apply to such distributions)
 - No tax-free distribution of capital to non-resident beneficiaries under s. 107(2). Distributions at FMV will give rise to capital gains taxes, pursuant to s. 107(2.1) of the *Income Tax Act*.

Canadian Wills and U.S. Beneficiaries

- Particular challenges arise when parents reside in Canada and have one or more children who are U.S. residents or dual citizens
- If some children reside in Canada and some reside in the U.S., the parents should consider establishing separate trusts in their Wills
- U.S. residents may face negative tax consequences if they are the beneficiaries of, and receive distributions from, a foreign trust
 - The benefit of establishing a U.S. trust on a testamentary basis is the benefit to the U.S. beneficiary of minimizing U.S. estate tax by not having the assets held in trust included in the determination of his or her “gross estate”

- A Practical Example

- Mr. and Mrs. Jones are residents of Canada and have always resided in Canada
- Mr. and Mrs. Jones have two adult children, Cindy and Joe. Cindy is a U.S. resident. Joe lives in Canada.
- Mr. and Mrs. Jones establish a testamentary trust for the benefit of Cindy and Joe in their Wills. The trust property will consist of several rental properties that Mr. and Mrs. Jones currently own in the GTA.
- The trustees of the trust are the same individuals as Mr. and Mrs. Jones' estate trustees: Joe, their Toronto accountant and Mr. Jones' brother, Steve, who also lives in Toronto

- Consequences of Mr. and Mrs. Jones' Planning
 - As a U.S. resident, Cindy cannot benefit from s. 104(13) of the *Income Tax Act* and have distributions of income taxed in her hands, with the trust claiming a deduction under s. 104(6)
 - Rather, distributions of income to Cindy will be subject to Part XIII withholding tax of 25%
 - This withholding tax rate is reduced by operation of the Canada-U.S. Tax Treaty to 15%, particularly given that the income “arises” within Canada (i.e., the source of the income is from the Canadian-*situs* properties)
 - Cindy faces additional tax and reporting obligations in the U.S. as the beneficiary of a foreign trust
 - These obligations include annual FBAR and FATCA filings

- Consequences of Mr. and Mrs. Jones' Planning (continued)
 - Trustees may want to distribute the capital of the trust to the beneficiaries, particularly prior to its 21st anniversary (s. 107(4) of the *Income Tax Act*)
 - Trustees will be able to distribute Joe's share to him on a tax-free basis, pursuant to s. 107(2) of the *Income Tax Act*
 - No tax-free distribution will be available to Cindy
 - Trust will be deemed to dispose of, and Cindy will be deemed to have acquired, the capital property at its FMV
 - Potentially sizeable capital gains tax obligation in Canada

- Consequences of Mr. and Mrs. Jones' Planning (continued)
 - Trust may elect to have the capital gain taxed at the trust level or trust may distribute the capital gain to Cindy, subject to Part XIII withholding tax
 - By distributing the capital gain to Cindy, the trust may be subject to Part XII.2 tax with respect to “designated income”

- A Change in the Facts

- Mr. and Mrs. Jones are residents of Canada and have always resided in Canada
- Mr. and Mrs. Jones have two adult children, Cindy and Joe. Cindy is a U.S. resident. Joe lives in Canada.
- Mr. and Mrs. Jones create two separate testamentary trusts in their Wills, one for Joe and one for Cindy.
- Cindy's trust is a U.S. resident trust, with U.S. trustees. Joe's trust is a Canadian resident trust, with Canadian resident trustees.
- Cindy's trust is established to minimize U.S. estate taxes that would otherwise be payable on her death

- Application of s. 94 of the *Income Tax Act* to the Changed Facts
 - When deceased, Mr. and/or Mrs. Jones will not be “resident contributors” to Cindy’s trust
 - Mr. and/or Mrs. Jones will be “connected contributors” to Cindy’s trust
 - However, Cindy is not a “resident beneficiary”
 - Therefore, s. 94 of the *Income Tax Act* does not apply.
 - Cindy’s trust will remain a U.S.-resident trust, with no Canadian reporting or remittance obligations to Mr. and/or Mrs. Jones’ estate, or to Cindy

- Consequences of the Changed Facts
 - With respect to the trust, Cindy will not be subject to any additional U.S. tax obligations or reporting requirements
 - The trust will be subject, however, to any applicable foreign asset reporting obligations in the U.S.
 - No part XIII withholding tax applies to the facts
 - Joe’s trust will be able to distribute the capital to him prior to the trust’s 21st anniversary and to make regular distributions of income to him
 - Depending on his income in a given year, the trust may decide to retain rental income and to distribute it to Joe in subsequent years, since the trust is taxed at graduated tax rates
 - Cindy will be able to keep the property in the trust and to avoid estate taxes payable in respect of the property’s fair market value on her death

Conclusion

- Always seek the advice of competent U.S. tax counsel and/or a U.S. accountant when conducting U.S. tax and estate planning
- It is crucial to be familiar with the U.S. gift, estate and generation-skipping tax regimes when dealing with clients who are U.S. citizens or have U.S. spouses or children
 - Practical solutions are available when dealing with cross-border issues in Wills
- Different planning strategies may be taken when drafting the Wills of spouses who are both U.S. citizens residing in Canada, or where one spouse is a U.S. citizen

- Canadian parents with U.S.-resident children present further challenges with respect to estate planning and Will preparation
- Need to ensure that Canadian Wills achieve the best possible U.S. and Canadian tax outcomes and that trustees are carefully selected to ensure that testamentary trusts are resident in the appropriate jurisdiction

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