CANADIAN TRUST SUBJECT TO US TAX

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In today's mobile society, often an extended family member may move to the United States, and suddenly a strictly Canadian estate plan has a US beneficiary. When the move occurs, Canadian practitioners should review the existing estate plan to determine what updates may be needed to make the plan more tax-effective on both sides of the border. Planning ahead for the US beneficiary can prevent unintended complications and taxes down the road.

On the income tax side, Canadian practitioners should consider any US reporting requirements. Assuming that the trust is not taxed as a grantor trust, in any year that the US beneficiary receives a trust distribution, a proportionate share of the trust's current-year income flows to the beneficiary and must be reported on the beneficiary's federal US income tax return (form 1040, "U.S. Individual Income Tax Return").

In addition, in any year that the US beneficiary receives a distribution from the Canadian trust, the beneficiary must file form 3520 ("Annual Return To Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts") to report the distribution to the IRS. If, in a given year, the US beneficiary receives a distribution of more than 50 percent of the trust's current income, the beneficiary must file FinCEN form 114 ("Report of Foreign Bank and Financial Accounts (FBAR)"). Furthermore, in any year that the US beneficiary receives a trust distribution, the beneficiary may have to file form 8938 ("Statement of Specified Foreign Financial Assets"), subject to special valuation rules that evaluate whether the beneficiary's financial interest in the trust exceeds the reporting threshold.

In addition to considering US federal income tax filing requirements, Canadian practitioners should consider US state income tax compliance. Many US states impose a state-level income tax on trusts, and the rules vary widely from state to state. New York, for example, will subject a trust to state-level income tax only if the trust was created by a New York resident or if the trust has New York-source income (such as rental income from New York real property). Other states, such as California, may attempt to tax a trust solely on the grounds that a beneficiary lives in

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the state, even if the trust has no other connection to the state.

If the trust does not distribute all of its net income each year, a Canadian practitioner should monitor whether the trust falls into the US accumulation distribution regime, and whether subsequent distributions to a US beneficiary are considered unfavourable accumulation distributions. In addition, if the trust owns shares in a private Canadian company, the Canadian practitioner should consider whether the controlled foreign corporation, passive foreign investment company and global intangible low-taxed income regimes may apply.

On the estate tax side, if the beneficiary who moved to the United States has a high net worth, the existing trust should be reviewed to determine whether there are any trust provisions that would cause the trust to be subject to US estate tax in the US beneficiary's estate. "High net worth" for these purposes may be a relatively low threshold. The US federal estate tax exemption is now set at $11.4 million (indexed annually for inflation), although some US states have only a $1 million exemption, meaning that even when federal estate tax is not an issue, state-level estate tax is still a real concern for many taxpayers.

What should the Canadian planner be looking for when reviewing the trust from a US estate tax perspective? The most significant consideration is whether the beneficiary is considered to have a general power of appointment over the trust. All assets over which an individual has a general power of appointment are included in the individual's US gross estate on the individual's death.

A power is a "general power of appointment" if the beneficiary has the unfettered ability to vest the trust assets in himself or herself. Most often, an undesired general power of appointment arises when the beneficiary also acts as a trustee. The problematic power may also exist in a non-fiduciary capacity—for instance, if the beneficiary can unilaterally withdraw assets from the trust during his or her lifetime, or if the beneficiary can direct the assets of the trust to any person or entity at death, including the beneficiary's estate.

A power is not considered a general power of appointment if it fits within three exceptions. The first and best known of the exceptions is the "ascertainable standard." If the trustee's distribution standard is limited to health, support, maintenance, and education, the power will not be a general power of appointment, and the beneficiary can safely act as his or her own trustee. The trust creator may wish to expand the distribution provision beyond the ascertainable standard, while still allowing a beneficiary to act as trustee. In that case, a non- beneficiary co-trustee can be appointed and granted a broader, or even unlimited, distribution power.

The second exception is that the beneficiary is deemed to not have a general power of appointment if the power is exercisable only in conjunction with the creator of the power. The third exception provides that a beneficiary is deemed not to have a general power of appointment if the power is exercisable only in conjunction with an individual who has a substantial interest in the trust that is adverse to the exercise of the power. For instance, if a trust is for the benefit of two beneficiaries and they are both trustees who must act unanimously, then their distribution power is likely not deemed to be a general power of appointment.

The Canadian planner should also review the trust to deter- mine whether the US beneficiary has a right to remove and replace the trustee, which may also be deemed to be a general power of appointment. Under US tax law, if the beneficiary can remove and replace the trustee, the beneficiary is deemed to have the powers of the trustee.

If the trustee's distribution standard is limited to the ascertainable standard, then the beneficiary may remove and replace the trustee without causing estate tax inclusion. However, if the trustee may make distributions for any reason, and the beneficiary has the power to remove and replace the trustee, the beneficiary is deemed to have the power to make distributions for any reason; thus, the beneficiary is deemed to have a general power of appointment. The trust documents can be written so that the beneficiary may remove a trustee, but if the power is exercised, the beneficiary must replace the trustee with someone who is deemed not to be related or sub- ordinate to the beneficiary, within the meaning of the US Internal Revenue Code. As long as the replacement trustee is deemed to be independent, the removal power will not result in a deemed power of appointment and thus US gross estate inclusion.