Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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Alter ego and joint partner trusts for U.S. persons

Can U.S. persons use them in tax and estate planning?

U.S. persons living in Canada who are thinking about implementing an alter ego trust (AET) or joint partner trust (JPT) should be aware of both the Canadian and U.S. tax and estate planning implications.

This article examines situations where a U.S. person who's a Canadian resident is the settlor, the settlor's spouse or a residual beneficiary of an AET or a JPT and the potentially punitive tax consequences that may arise due to differences in the Canadian and U.S. tax treatment of these trusts.

This article is intended for Canadian residents who are U.S. persons (including a U.S. citizen, U.S. green card holder and a U.S. domiciliary). Also, please note that for Canadian tax purposes, a common-law partner is treated the same way as a married spouse. For U.S. tax purposes, however, a spouse is only someone to whom you are legally married (a common-law partner is not generally considered to be your spouse). For the purposes of this article, any reference to a spouse only includes someone to whom you are legally married. If you're in a common-law relationship, you'll need to seek qualified cross-border tax advice when considering an AET or a JPT, as the tax implications may be different.

Overview of AETs and JPTs

An AET is an inter vivos Canadian trust created after 1999 by a person (the settlor) who is a Canadian resident and is age 65 or over at the time they create the trust. Only the settlor of an AET can benefit from the trust during their lifetime. The settlor of the trust must be entitled to receive all of the income earned in the trust while they are alive, and no other person can receive or use income or capital from the trust during the settlor's lifetime. When the settlor of an AET passes away, the trust property may be

distributed outright to their desired beneficiaries (such as a spouse or children) or may continue to be held in trust or distributed to successive trusts for the benefit of their beneficiaries.

If a settlor is age 65 or over and wants to include their spouse as a beneficiary of a trust, they can use a JPT. A JPT differs from an AET in one aspect. Under the terms of a JPT, the settlor and their spouse must be entitled to receive all income from the trust prior to the death of the second spouse. As well, no one other than the settlor or their spouse can receive or use any income or capital from the trust before the death of the second spouse. This is different than naming your spouse as a residual beneficiary of a trust (as in the case of an AET), where your spouse can only benefit from the trust property upon your death.

AETs and JPTs may be used as part of a Canadian resident's estate plan for a number of reasons, including probate tax minimization and incapacity planning. For more information about AETs or JPTs from a Canadian tax and legal perspective, ask your RBC advisor for a separate article on that topic.

While these trusts may offer estate planning benefits from a Canadian perspective, there are other considerations when U.S. persons are involved. In particular, the differences in the Canadian and U.S. tax treatment of these trusts may result in the double taxation of the capital gains earned in such trusts. It's therefore important to consult with a qualified cross-border tax and legal advisor to determine whether these types of trusts make sense for you or whether another type of trust may be more suitable. A separate article on the topic of estate planning for U.S. persons living in Canada includes a discussion of the use of trusts for U.S. persons. Please ask your RBC advisor for a copy of that article.

Canadian income tax treatment of an AET and a JPT

As the settlor of an AET or a JPT, you may transfer capital property (e.g. stocks, bonds, mutual funds, personal-use property such as your principal residence, and private company shares) to the trust on a tax-deferred basis at the property's adjusted cost base (ACB). Any accrued capital gains or losses on the capital property will not be realized until the property is sold by the trust or you, or your surviving spouse (in the case of a JPT), pass away. You may also choose to transfer capital property to an AET or a JPT at fair market value (FMV) in order to realize an accrued gain on the property. If you choose to transfer capital property with accrued losses at FMV, you need to be mindful of the superficial loss rules. A discussion of the superficial loss rules is beyond the scope of this article (for more information on the superficial loss rules, ask your RBC advisor for a separate article on this topic).

If a settlor is age 65 or over and wants to include their spouse as a beneficiary of a trust, they can use a JPT. A JPT differs from an AET in one aspect. Under the terms of a JPT, the settlor and their spouse must be entitled to receive all income from the trust prior to the death of the second spouse.

If your spouse is age 65 or over, they can also transfer capital property to a JPT on a tax-deferred basis. However, when both you and your spouse transfer property to a JPT, you need to be mindful of the attribution rules when income and capital gains are allocated to you or your spouse. These rules will attribute income or capital gains earned on the property back to the individual who contributed that property to the trust. As a result, the income and capital gains may not be taxed in the hands of the person it was allocated to. These rules may result in a significant administrative burden due to the requirement to keep track of the income and gains that are attributable to each spouse on each property that's contributed to the trust.

As a beneficiary of an AET or a JPT, you must be entitled to receive all of the income of the trust during your lifetime. This means all of the income must be paid or made payable to you, or to you and/or your spouse in the case of a JPT. In general, the trust income paid or made payable to you will be taxed at your marginal tax rate. In the case of a JPT, if the income paid or made payable to your spouse is traceable to property you contributed to the trust, the income will be attributed back to you and taxed in your hands while you're alive.

It's important to note that income of a trust for purposes of an AET or a JPT is income calculated under trust rules, not the Income Tax Act. This means the beneficiary of an AET or a JPT does not have to be entitled to capital gains under the terms of the trust to qualify as an AET or a JPT. As a result, capital gains of a trust can only be paid or made payable to a beneficiary of an AET or a JPT if the trust agreement allows for this. If it doesn't, capital gains may be taxed in the trust at the top marginal tax rate in the trust's province or territory of residence. Alternatively, if the AET or JPT is structured so that you, the settlor (or your spouse in the case of a JPT), maintain control of the funds that you (or your spouse) contributed to the trust (i.e. you or your spouse are the sole trustee) or you or your spouse are a capital beneficiary of the trust, then

the capital gains may be attributed back to you (or your spouse) and taxed in your (or your spouse's) hands at your (or their) marginal tax rate.

Most Canadian resident trusts are subject to a 21-year deemed disposition rule. This rule deems a trust to dispose of its property at FMV on the 21st anniversary of the creation of the trust and every 21 years thereafter, triggering unrealized capital gains or losses. The trust property is treated as if it's been sold, even though it hasn't. Any net capital gains realized as a result of the 21-year deemed disposition are taxed in the trust at the top marginal tax rate in the trust's province or territory of residence and can't be allocated out to a beneficiary of a trust and taxed in their hands.

The 21-year rule does not apply to an AET or a JPT. Instead, the first deemed disposition date for an AET is the date on which the settlor dies. In the case of a JPT, the first deemed disposition date is the date of death of the last to die among the settlor and their spouse. When the settlor of an AET or the last spouse of a JPT passes away, the trust is deemed to have disposed of and reacquired the property at its FMV on the date of death, triggering unrealized gains and losses. Any net capital gains (gains minus losses) arising on the death of the settlor, or in the case of a JPT, on the death of the surviving spouse, will be taxable in the trust at the top marginal tax rate in the trust's province or territory of residence.

U.S. tax treatment of an AET and a JPT

The U.S. tax treatment of an AET and a JPT is based on two separate tax systems — the U.S. income tax system and the U.S. transfer tax system. The U.S. transfer tax system consists of a U.S. gift tax, U.S. estate tax and U.S. generation-skipping transfer tax (GSTT). Some of the key U.S. tax considerations under each of these U.S. tax systems is discussed in the following sections.

U.S. income tax system

In general, when a U.S. person (i.e. the settlor, also referred to as the grantor) transfers property to a Canadian trust (referred to as a foreign trust for U.S. purposes), and the income or capital of the trust can revert back to the grantor, or the income of the trust is for the benefit of only the grantor's spouse during their lifetime, the trust will be regarded as a foreign grantor trust. Therefore, an AET or a JPT is generally viewed as a foreign grantor trust during the grantor's lifetime and is disregarded for U.S. income tax purposes.

A Canadian AET or JPT may also be considered a non-U.S. trust for U.S. income tax purposes and may be subject to the U.S. foreign trust rules. The U.S. foreign trust rules are complex, and a detailed discussion of the rules is beyond the scope of this article.

As the grantor of an AET or a JPT, you can transfer property to the trust without immediate U.S. income tax consequences, at the ACB of the property. If you elected under Canadian tax rules to transfer property to an AET or a JPT at FMV, under the Canada-U.S. Income Tax Treaty, you may also elect for U.S. tax purposes to transfer the property at its FMV. You are subject to income tax annually on the income and net capital gains earned in the trust each year.

In the case of a JPT, if your spouse also transfers property to the trust, you and your spouse will each be considered a grantor in respect of the portion each of you have contributed to the trust. Each of you will be subject to U.S. income tax annually on the income and net capital gains relating to the portion of the trust you're deemed to own. Determining what portion of the trust each of you owns may be complex and is beyond the scope of this article.

When the grantor of an AET or a JPT dies, there are generally no U.S. income tax consequences to the grantor. In the case of a JPT, the surviving U.S. spouse will become the grantor of the trust if they have the power exercisable solely to vest the corpus (i.e. capital) or the income and net capital gains of the trust in themselves. This would be the case, for example, if the spouse became the sole trustee of the trust. As the grantor of the trust, the surviving spouse will be subject to U.S. income tax on all of the income and net gains earned in the trust annually.

Under the U.S. foreign trust rules, there are additional U.S. filing requirements that may apply where a U.S. person has an interest in a foreign trust. You should consult with a qualified cross-border tax advisor to determine what specific forms may need to be filed.

U.S. transfer tax system

As a general overview, U.S. gift tax may apply to gifts made by U.S. persons or to a distribution from a trust settled by a U.S. person during their lifetime in certain circumstances. U.S. estate tax may apply to the FMV of a U.S. person's worldwide estate upon their death. GSTT imposes another layer of gift or estate tax if a gift or bequest is made by a U.S. person or from a trust settled by the U.S. person, to a "skip person" such as a grandchild or great-grandchild. For more information on the U.S. transfer tax system, please ask your RBC advisor for a separate article on that topic.

As the grantor of an AET or a JPT, you can transfer property to these trusts free of U.S. gift tax provided you haven't given up "dominion and control over the property" (i.e. the power to dispose of trust property or the power to revest beneficial title to the property). For example, if the trust is structured so that you're not a trustee and you do not have the power to revoke the trust or you do not

maintain certain powers(such as determining beneficial enjoyment of the trust property or determining what can be distributed), then U.S. gift tax may apply when you transfer property to the trust.

For U.S. estate tax purposes, if you (the grantor) have a retained interest in the property transferred to an AET or a JPT (i.e. you have a right to the possession or enjoyment of the property in the trust and to the income from it, or you can determine beneficial enjoyment of the property or income), the property in the trust will be included in your taxable estate when you pass away. You may be able to minimize, eliminate or defer your U.S. estate tax liability on death by implementing certain planning, such as transferring the property to your U.S. spouse or to a trust structured in a certain manner for your spouse's benefit.

If, as a beneficiary, you have a general power of appointment over property in the trust, the property will be included in your taxable estate when you pass away. The holder of a general power of appointment is treated as if they're the owner of the property that's subject to the power, whether or not the power is actually exercised. A general power of appointment exists where a beneficiary has the power to direct the trust property to anyone, including themselves, their heirs or the creditors of their estate. Note, if you're the sole trustee of the trust and a beneficiary, you will be considered to have a general power of appointment.

As mentioned, there is a separate article discussing estate planning for U.S. transfer tax. Please ask your RBC advisor for a copy if you would like more information.

Potential tax issues for U.S. persons with an interest in an AET or a JPT

The main tax issues surrounding an AET or a JPT when U.S. persons are involved stem from the mismatch in timing of taxation, as well as the entity subject to tax. This can present in many ways, and the common scenarios are discussed in the following sections.

Tax treatment for a U.S. grantor

During the grantor's lifetime

Provided you have not given up dominion and control over property transferred to an AET or a JPT during your lifetime, the U.S. and Canadian tax treatment with respect to these trusts generally coincide. For example, you can transfer capital property to an AET or a JPT without triggering Canadian or U.S. tax. Assuming both income and capital gains are taxed in the grantor's hands for Canadian tax purposes, the reporting of income should match in both countries. Foreign tax credits may be claimed to minimize the risk of double taxation. However, you must comply with U.S. foreign trust compliance

If, as a beneficiary, you have a general power of appointment over property in the trust, the property will be included in your taxable estate when you pass away.

reporting requirements, which may result in additional tax return preparation fees.

Note that there could be a potential for double taxation where there is a disposition of U.S. real property held by an AET or a JPT, if the gains realized on the disposition of the trust property are taxable in the trust for Canadian tax purposes and in your hands for U.S. tax purposes. This is because a foreign tax credit can't be claimed by the trust for any U.S. income tax that you've paid personally. If a gain is realized on most other property held by the trust, a foreign tax credit may be claimed on your personal U.S. income tax return for taxes paid by the trust.

When the grantor passes away

For Canadian tax purposes, when you, the settlor/grantor of an AET pass away, the trust is deemed to dispose of its property at FMV, resulting in the realization of all accrued capital gains and losses. The net capital gains are subject to tax in the trust at the highest marginal tax rate in the trust's province or territory of residence. In the case of a JPT, a deemed disposition is not triggered until the death of the surviving spouse, so there's no Canadian income tax at the time of your death (assuming you, the grantor, die first).

From a U.S. tax perspective, there's generally no U.S. income tax triggered with respect to the AET or JPT property upon your death. However, you may be subject to U.S. estate tax on the FMV of the property held in the trust. As discussed earlier, there may be ways to defer, minimize or eliminate your U.S. estate tax liability, including by transferring the property to your surviving spouse directly or to a trust structured in a certain manner for the benefit of your spouse. If the trust property is being transferred to someone other than a spouse, you may also be subject to U.S. GSTT if the beneficiary is a skip person.

If there is a U.S. estate tax liability on your death, there could be double taxation where the AET or JPT holds U.S. situs property (i.e. property located in the U.S. or property that has a U.S. connection, such as shares of a publicly traded U.S. company). This is because neither an AET nor a JPT can claim a foreign tax credit to reduce its taxes payable (if any) for U.S. estate tax incurred by your estate on U.S. situs property. In the case of an AET, if the trust holds only Canadian situs property (i.e. property located in Canada or property that has a

Canadian connection, such as shares of publicly traded Canadian corporations), the trust's Canadian tax liability can be claimed as a credit in determining your U.S. estate tax liability on that property. Unfortunately, in the case of a JPT where you are the grantor of the trust and you die first, since there's no Canadian income tax incurred until the death of the second spouse, no credit will be available to reduce your U.S. estate tax liability even where the trust holds Canadian situs property. Since your estate can't go back and claim a credit on your U.S. estate tax return for any Canadian tax eventually incurred on the disposition of Canadian situs property, whether during the surviving spouse's lifetime or on their death, there is still a double taxation concern.

Tax treatment for the U.S. spouse of the grantor

During the grantor's lifetime

During your lifetime, your U.S. spouse is not subject to Canadian or U.S. income tax on income earned in your AET or in a JPT, provided your spouse has not contributed their own property to the JPT. As a result, there's generally no adverse Canadian or U.S. income tax issues for your U.S. spouse while you're alive. If your spouse predeceases you, they may be subject to U.S. estate tax on assets held in a JPT if they have a general power of appointment over the trust assets. Your spouse would also have to include any property they contributed to a JPT in which they have a retained interest as part of their taxable estate for U.S. estate tax purposes. A review of other possible tax implications if your spouse dies first is outside the scope of this article.

Upon the grantor's death

AET

Upon your death, the AET is deemed to dispose of its property at FMV for Canadian tax purposes, bumping up the ACB of the property to the FMV on the date of death. For U.S. tax purposes, the ACB of the trust property is also be bumped up to the FMV on the date of death. The AET deed will determine how and to whom the trust property is to be distributed.

If the trust deed of your AET provides that the trust property is to be distributed outright to your surviving spouse, the trustee can transfer the property at the bumped-up ACB to your spouse without triggering any Canadian tax. The property may also be distributed to your spouse for U.S. tax purposes at the bumped-up ACB without triggering U.S. tax, provided there hasn't been any income earned in the trust since your death or all income earned in the trust since your death has already been paid out of the trust at the time the property is being distributed to your spouse. Once the property is held outright by your spouse, any future income and net capital gains earned on the property will be subject to Canadian and U.S. tax in your spouse's hands in the same tax year. Foreign tax credits can be claimed to avoid double taxation.

If the property continues to be held in the AET for the benefit of your spouse, or is transferred to a successive trust for the benefit of your spouse, then for Canadian tax purposes, income and net capital gains earned in the trust will generally either be taxable in the trust or in your spouse's hands if the income and net gains is paid or made payable to them.

The U.S. tax treatment of the income and net capital gains earned in the trust will depend on how the U.S. classifies this trust, i.e. as a foreign grantor or non-grantor trust. Assuming your spouse does not have the power to revest the capital or income of the trust in themselves (i.e. they're not a trustee of the trust), the trust will be classified as a foreign non-grantor trust. If the trust is regarded as a foreign non-grantor trust, then income and net capital gains are taxable to your spouse for U.S. tax purposes in the year they're distributed to them. If a portion of the distribution from the trust represents income that was earned in the trust in a previous tax year but not distributed in that year (i.e. accumulated income), your spouse may be subject to the U.S. throw-back rules. Otherwise, the amount of the distribution that's in excess of income earned in the current year and the income accumulated in the trust in previous years may be received tax-free as a distribution of capital from the trust at the trust's ACB. When the throw-back rules apply, they result in punitive U.S. taxation, as the income and net gains will be subject to tax at the beneficiary's marginal tax rate and an interest penalty will be levied as well. In addition, your spouse will have additional U.S. filing requirements with respect to their interest in the foreign trust.

For Canadian tax purposes, when your spouse dies, the AET or a successive trust is not subject to a deemed disposition. Instead, the trust is subject to a deemed disposition every 21 years from the date the trust is created, i.e. the date of death of the settlor of an AET, and every 21 years thereafter. Any net capital gains arising from the 21-year deemed disposition will be taxed in the trust at the top marginal tax rate in the trust's province or territory of residence.

If the trust property is subject to the 21-year deemed disposition rules, and net capital gains are realized for Canadian tax purposes, there could be the potential for double taxation if the trust is a foreign non-grantor trust for U.S. tax purposes. This is because there would be Canadian tax payable now by the trust on the net gains but no immediate U.S. income tax on them. If the

trust property is sold in the future and the capital gain is subject to U.S. tax at that time in the trust or in the hands of a beneficiary, there could be double taxation. In this case, the trust would not be able to claim a foreign tax credit for the Canadian taxes paid in a previous tax year. Double taxation may be prevented if the property subject to the 21-year deemed disposition rules can be transferred to the Canadian resident beneficiary at its ACB for both U.S. and Canadian tax purposes before the 21st anniversary of the trust and the accrued gains are taxed in the hands of the beneficiary.

JPT

In the case of a JPT, upon your death, there is no disposition of the trust property for Canadian tax purposes and the ACB of the property does not change. However, for U.S. income tax purposes, the ACB of the trust property will be bumped up to the FMV on the date of death. Your surviving spouse will continue to be entitled to receive all of the income of the JPT for their lifetime. Depending on the terms of the trust, they may also be entitled to the capital of the trust during their lifetime. Any income and net capital gains allocated to your spouse will be taxed in their hands for Canadian tax purposes.

For U.S. income tax purposes, if your surviving spouse has the power exercisable solely by themselves to vest the capital or the income of the JPT in themselves, the JPT will be classified as a foreign grantor trust and your spouse will become the grantor. If that's the case, your spouse will be subject to tax in the U.S. on all income and net capital gains earned in the trust.

As the ACB of the trust property is different for Canadian and U.S. tax purposes, the amount of the gains and losses triggered for Canadian and U.S. income tax purposes may be significantly different. However, foreign tax credits may be claimed by your spouse to minimize double taxation. If the trust deed does not allow your spouse to access the capital of the trust and capital gains are taxable to the trust for Canadian tax purposes, there may be a double taxation issue, as previously discussed, if gains are realized on the disposition of U.S. real property, and the trust is considered to be a foreign grantor trust for U.S. tax purposes (i.e. the gains are taxable to your spouse personally for U.S. tax purposes).

When the surviving spouse of the grantor passes away

When your surviving spouse passes away, for Canadian tax purposes, they will generally be deemed to dispose of any property they hold directly at FMV on their date of death, triggering any accrued gains and losses. If the property is held by a JPT, there will also be a disposition of the trust property at FMV on the date of your spouse's death. Your spouse will be subject to Canadian tax on any net capital gains that have accrued on the property owned directly, whereas the JPT will be subject to Canadian tax on the net capital gains that have accrued on the trust property. As mentioned, if any property remained in the AET on your death for the benefit of your spouse or the property was transferred from the AET on your death to a successive trust for the benefit of your spouse, no taxable event (deemed disposition) will occur on your spouse's death.

For U.S. income tax purposes, if your surviving spouse has the power exercisable solely by themselves to vest the capital or the income of the JPT in themselves, the JPT will be classified as a foreign grantor trust and your spouse will become the grantor.

While your spouse is generally not subject to U.S. income tax upon their death, they may be subject to U.S. estate tax on the value of the property your spouse owns directly. U.S. estate tax may also apply to property held in a JPT, property that remained in the AET on your death for their benefit, or property transferred to a successive trust for their benefit in certain circumstances (for example, where your spouse had a general power of appointment over the trust property). If your spouse is subject to U.S. estate tax on property owned directly or property held in a trust for their benefit and the property is transferred to a skip person upon your spouse's death, your spouse may also be subject to GSTT.

If the property is held directly by your spouse, foreign tax credits may be claimed to reduce their Canadian income tax or U.S. estate tax liability and minimize double taxation. If the property is held in a trust, however, there is the potential for double taxation. For example, in the case of a JPT, for Canadian tax purposes, the trust is subject to tax on any accrued gains on the property on your spouse's death. For U.S. tax purposes, your spouse may be subject to U.S. estate tax on the FMV of the property held in the trust. The JPT is not able to claim a foreign tax credit for U.S. estate tax paid on U.S. situs property. Where U.S. estate tax exposure exists, you may wish to consider having the JPT only invest in Canadian situs property.

If the property continues to be held in the AET after your death for your spouse's benefit or was transferred to a successive trust for the benefit of your spouse, there may also be an element of double taxation if the value of the trust assets are included in your spouse's

U.S. taxable estate and subject to U.S. estate tax. This is because there will generally be no Canadian tax implications to the trust when your spouse passes away. The accrued capital gains on the trust property will only be realized and subject to Canadian tax when the property is disposed of or is deemed to have been disposed of by the trust. Your spouse's estate will not be able to go back and claim a credit for the Canadian taxes paid to reduce the U.S. estate tax liability.

Tax treatment for residual U.S. beneficiaries

While the grantor or spouse is alive

Residual beneficiaries you include in an AET or a JPT are not subject to Canadian or U.S. income tax while you, or you and your spouse in the case of a JPT, are alive. There's also no U.S. estate tax exposure to them while you, or you and your spouse in the case of a JPT, are alive.

When the grantor or spouse passes away

When you (or the survivor of you and your spouse in the case of a JPT) pass away, the trust may continue for the benefit of the residual beneficiaries. Alternatively, the trust may be wound up, and the property in the trust may be transferred to the residual beneficiaries directly or to successive trusts for the benefit of the residual beneficiaries.

As mentioned, the ACB of the AET or JPT property is adjusted to the FMV on the date of your death, or the surviving spouse's death in the case of a JPT, for both Canadian and U.S. tax purposes. If the trust deed provides that the property is to be distributed outright to your beneficiaries, the trustee can transfer the property at the bumped-up ACB to them without triggering any Canadian tax. The trustee may also be able to transfer the property at the bumped-up ACB without triggering U.S. tax, provided no income has been earned in the AET since the grantor's death (or in the JPT since the surviving spouse's death) or any income that has been earned has already been paid out to the beneficiary. Any future income and net capital gains earned on the property will be subject to Canadian and U.S. tax in your beneficiary's hands. The timing of the income inclusion for both Canadian and U.S. tax purposes should match, and foreign tax credits can be claimed to avoid double taxation.

If the property remains in trust for the benefit of your residual beneficiaries, for Canadian tax purposes, income and capital gains will generally either be taxable in the trust at the top marginal tax rate in the trust's province or territory of residence or taxable to your beneficiary if the income and capital gains is paid or made payable to them. For U.S. tax purposes, the residual beneficiaries will generally only be subject to U.S. income tax in the year they receive a distribution from the trust. To the extent the property remains in a Canadian trust for the benefit of your beneficiary, the U.S. foreign trust rules and the associated foreign tax compliance reporting will apply. The trust may be regarded as a foreign non-grantor trust; therefore, punitive U.S. tax rules (the U.S. throw-back rules) discussed earlier will apply unless income and gains earned by the trust each year are distributed to the residual beneficiaries annually. The trust may also be regarded as a grantor trust if the U.S. residual beneficiaries have the power to vest the capital or income of the trust in themselves.

Residual beneficiaries you include in an AET or a JPT are not subject to Canadian or U.S. income tax while you, or you and your spouse in the case of a JPT, are alive.

Upon the death of a residual beneficiary

On the residual beneficiary's death, they will generally be deemed to dispose of any property they own directly at FMV for Canadian tax purposes (unless the property is passing to their spouse). Any property held in a trust for their benefit will not be subject to a deemed disposition on their death for Canadian tax purposes. Instead, any accrued gain or losses will not be realized until the property is disposed of or subject to the 21-year deemed disposition. As discussed earlier, if the trust property is subject to the 21-year deemed disposition rules, and net capital gains are realized for Canadian tax purposes, there could be the potential for double taxation. This is because there would be Canadian tax payable as a result of the deemed disposition date by the trust but no U.S. income tax payable until the property is sold. If the trust property is later sold and the gain is subject to U.S. tax in the hands of the trust or the beneficiary, there's no ability to claim a foreign tax credit for the Canadian taxes paid by the trust in a previous year to minimize double taxation.

When residual beneficiaries pass away, they may be subject to U.S. estate tax on the property they own directly and on the property held in a trust where the beneficiaries have a general power of appointment over the property. Foreign tax credits may be claimed to minimize double taxation where the residual beneficiary is subject to Canadian income tax and U.S. estate tax. However, there's still an element of double taxation when a residual beneficiary is subject to U.S. estate tax on trust property on death but the trust property is not subject to Canadian tax, since there's no disposition of that property on death. If a residual beneficiary is subject to U.S. estate tax on death on property owned directly or with respect to property held in a trust and the property is transferred to a skip person on their death, GSTT may also apply.

Conclusion

An AET or a JPT offers estate planning opportunities for U.S. persons living in Canada. However, there are some special considerations due to differences in the Canadian and U.S. tax treatment of these trusts that may potentially result in double taxation of capital gains earned in the trust. As well, due to the U.S. foreign trust rules, income and capital gains earned in the trust may be punitively taxed in the U.S. As there are other types of trusts that may be used by U.S. persons for estate planning purposes, it's important to consult with a qualified cross-border tax and legal professional to determine whether an AET or a JPT makes sense in your situation or whether another type of trust or strategy can be used to meet your estate planning needs.

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NAV0272 (10/2026)