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INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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U.S. foreign trust rules for Canadian trusts

Additional U.S. tax reporting and issues for U.S. persons

The U.S. tax system includes complex U.S. foreign trust rules. These rules may affect U.S. persons (U.S. citizens, U.S. green card holders and U.S. residents) who have an interest or involvement with a non-U.S. trust (in this article referred to as a foreign trust), such as a Canadian resident trust. The U.S. foreign trust rules result in additional U.S. reporting requirements for U.S. persons that do not apply when they have an interest in a U.S. domestic trust. They may also result in punitive U.S. tax and/or double taxation of income earned in the trust. While trusts are an important tool in Canadian tax and estate planning, these foreign trust rules may make them more complicated where they involve a Canadian resident who is also a U.S. person.

This article provides an overview of the U.S. foreign trust rules as well as the various U.S. tax issues and reporting that may apply when a Canadian trust includes a U.S. person(s).

Any reference to a spouse in this article refers to a person to whom you are legally married. For U.S. tax purposes, a spouse does not generally include a common-law partner. As well, unless otherwise stated, this article only addresses U.S. federal tax considerations.

What is a trust for U.S. tax purposes?

A trust is generally defined as an arrangement created by a Will or inter vivos declaration by which title to property is held by a person (or persons), referred to as the "trustee," with a fiduciary responsibility to conserve or protect the property for the benefit of another person (or persons), called the "beneficiary." The U.S. foreign trust rules will only apply to a foreign trust if it is recognized as a trust for U.S. tax purposes.

An arrangement or relationship that qualifies as a trust under the tax laws of a foreign country may not necessarily be classified as a trust under U.S. tax laws and would not be subject to the foreign trust rules. For example, if a foreign trust is actively engaged in trade or the operation of a business, the trust may be considered a "business trust" for U.S. tax purposes and taxed as a corporation or partnership rather than a trust. Similarly, certain trusts in a foreign country may be classified by the U.S. as "an investment trust," and also taxed as a partnership or corporation. Examples of business and investment trusts include Canadian mutual funds, exchange traded funds and real estate investment trusts.

Some examples of Canadian trusts that may be classified as foreign trusts for U.S. tax purposes, and subject to the foreign trust rules, include an inter vivos (living) trust used for income splitting with family members or as part of an estate freeze and an alter-ego or joint partner trust. Canadian registered plans, including a registered retirement savings plan, registered retirement income fund, tax-free savings account, tax-free first home savings account, registered education savings plan, and registered disability savings plan may also qualify as foreign trusts for U.S. income tax purposes.

U.S. domestic versus foreign trust

The classification of a trust as a foreign or domestic trust will impact the U.S. taxation of and reporting requirements for the trust, its U.S. owners and its beneficiaries. A trust that does not meet both the "court test" and the "control test" does not qualify as a U.S. domestic trust and will be considered to be a foreign trust. Note that it is possible a trust set-up in a foreign country may also qualify as a U.S. domestic trust if it meets both of these two tests.

U.S. court test

To meet this test, a U.S. court must be able to exercise primary supervision over substantially all issues relating to the administration of the trust. Four situations where the court test would be met include:

An arrangement or relationship that qualifies as a trust under the tax laws of a foreign country may not necessarily be classified as a trust under U.S. tax laws and would not be subject to the foreign trust rules.

- If a trust is registered with a U.S. court;
- If all fiduciaries of a testamentary trust created pursuant to a Will that is probated within the U.S. (other than ancillary probate) have been qualified as trustees of the trust by a court in the U.S.;
- If the fiduciaries and/or beneficiaries of an inter vivos trust take steps with a court within the U.S. that cause the administration of the trust to be subject to the primary supervision of that U.S. court; or
- If both a U.S. court and foreign court are able to exercise primary supervision over the administration of the trust.

If the trust instrument is silent as to where the trust is to be administered and it is administered exclusively in the U.S., then may also meet the court test unless the trust document has an automatic migration provision. This provision would cause the trust to migrate from the U.S. if a U.S. court attempts to assert jurisdiction directly or indirectly over the trust.

U.S. control test

To meet this test, one or more U.S. persons must have the authority to control all substantial decisions of the trust. The term "persons" is not limited to trustees of the trust but could include a settlor of a trust who retains the power to remove or replace a trustee or beneficiary of a trust who is given a special power to appoint their share to remainder beneficiaries.

Substantial decisions include:

- Whether and when to distribute the trust's income or capital;
- The amount of any distributions;
- The selection of a beneficiary;
- Whether to terminate the trust;
- Whether to compromise;
- Whether to remove, add or replace a trustee; or
- Investment decisions.

The term "control" means having the power, by vote or otherwise, to make all of the substantial decisions of the trust, with no other person having power to veto any of the substantial decisions. If any substantial decision requires a unanimous decision of the trustees and one of the trustees is not a U.S. person, the trust will not meet the control test. However, if all substantial decisions require a majority vote and a majority of the trustees are U.S. persons, then the trust will satisfy the control test. If a non-U.S. person or U.S. entity has the power to veto substantial decisions made by a U.S. trustee, the control test will not be met.

Foreign grantor versus foreign non-grantor trust

The classification of a foreign trust as a grantor or non-grantor trust is important because it impacts who is taxed on the income of the trust for U.S. tax purposes, i.e. the grantor, beneficiary or trust, and when they are taxed.

In general, income from a foreign grantor trust is taxed in the hands of the trust's grantor, rather than to the trust itself or to the trust's beneficiary. In contrast, income from a foreign non-grantor trust is generally taxed when distributed to a U.S. beneficiary, except to the extent U.S. source or effectively connected income is earned and retained by the trust. In such a case, the foreign non-grantor trust would pay U.S. income tax for the year such income is earned.

Foreign grantor trust

A foreign trust is generally classified as a foreign grantor trust where an individual (the grantor) directly or indirectly gratuitously transfers property to the trust but retains certain powers over the income or capital of the trust. Any powers held by the spouse of the transferor are attributed back to the transferor, for purposes of determining whether the transferor is a grantor. Specific situations where a trust may be classified as a foreign grantor trust are set out below.

U.S. grantor with U.S. beneficiary

If a U.S. person transfers (which includes gifts or loans) property directly or indirectly to a foreign trust and the trust has one or more U.S. beneficiaries, the foreign trust is by default a foreign grantor trust. This is the case whether or not the U.S. grantor has retained powers over the income or capital of the trust. There are a number of exceptions to this rule, including where the transfer to the trust occurs by reason of death or is for fair market value (FMV) consideration. A loan that complies with the "qualified obligation rules" is not considered a transfer to a trust. A discussion of the qualified obligations rules is outside the scope of this article. There's also an exception for transfers to charitable and employee benefit trusts for the benefit of U.S. beneficiaries.

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A foreign trust is presumed to have a U.S. beneficiary unless the U.S. person who transferred property to the trust can demonstrate that under the terms of the trust, no part of the income or capital of the trust may be paid to or accumulated for the benefit of a U.S. person during the taxable year or paid to or for the benefit of a U.S. person if the trust were to terminate at any time during the taxable year. Even when these terms are included in the trust instrument, the trust may still be classified as a foreign grantor trust if the trust can be amended by its terms or local law.

If a trust does not otherwise meet the classification as a foreign grantor trust and it then acquires a U.S. beneficiary or is deemed to acquire one (for example, if a beneficiary moves to the U.S. and becomes a U.S. person within five years after the grantor made a transfer to the trust), the foreign trust may become a foreign grantor trust and the U.S. person who transferred property to the trust will be considered the grantor.

U.S. grantor with no U.S. beneficiary

If the trust does not include U.S. beneficiaries or there is no possibility of there being a U.S. beneficiary, the foreign trust will be a foreign grantor trust if a U.S. person transfers property to the trust and has one or more powers, including:

- A reversionary interest in the income or capital of the trust, the value of which exceeds 5% of the value of the trust property (i.e. there is more than a 5% probability of the property returning to the grantor);
- The power to deal with or borrow from the trust without adequate and full consideration or security; or
- The power to reacquire trust property by substituting property of equal value.

The trust will also be a foreign grantor trust if the grantor or a "non-adverse party" has the power to control the beneficial enjoyment of the income and capital of the trust without the consent of an adverse party or has the power to revoke the trust. A non-adverse party is a person who does not have a substantial beneficial interest in the trust that could be adversely affected by the exercise or non-exercise of a power, which the person possesses, and does not have a power of appointment over the trust property. An example of a non-adverse party is an independent trustee, such as a professional trustee. An example of an adverse party is a beneficiary of a trust.

As well, a trust will be considered a foreign grantor trust if the income of the trust can be used for the benefit of the grantor and their spouse.

Non-U.S. grantor

Where a non-U.S. person transfers property to a foreign trust, the trust will be classified as a foreign grantor trust if, in addition to the non-U.S. person meeting the definition of a "grantor" under U.S. laws, one of the following also applies:

- The trust provides that only the grantor and/or their spouse can benefit from the trust during the grantor's lifetime; or
- The trust provides the grantor (either unilaterally, or in some cases with the consent of another person) the power to revoke the trust at any time and to revest in (i.e. restore ownership of) the property transferred to the trust; or
- The trust was funded prior to September 19, 1995, and the grantor and/or their spouse was then and still is a beneficiary;

Death of grantor and classification of the trust

On the death of a grantor of a foreign grantor trust, the trust may continue to be classified as a foreign grantor trust. This will be the case where the surviving spouse of the grantor is a U.S. person and a beneficiary of the trust and is provided with the power to revest the income or capital of the trust in themselves. In this case, the spouse becomes the grantor of the trust. This would also be the case where the grantor passes away and leaves a U.S. beneficiary with a general power of appointment or withdrawal power over the trust property (i.e. they have the power to vest the capital or income of the trust in themselves). In such a case, the beneficiary will become the grantor of the trust. If a beneficiary is not given these powers, the trust may be reclassified as a foreign non-grantor trust as of the date of death of the grantor.

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U.S. tax treatment of foreign grantor trust

Foreign grantor trusts are ignored for U.S. income tax purposes. The person who is treated as the grantor is considered to own the income from the trust property. If the grantor is a U.S. person, they are required to include the income, deductions, credits, gains and losses of the trust on their individual U.S. income tax return (irrespective of whether or not the trust has made a distribution to them or to beneficiaries (who are not the grantor) or whether they are entitled to income, including capital gains, of the trust).

Note that the classification of a Canadian trust as a grantor trust could create the potential for double taxation where the income and capital gains of the trust are attributed and taxable to the grantor for U.S. tax purposes, but to the beneficiary of the trust (who is not the grantor) for Canadian tax purposes.

Foreign non-grantor trust

A foreign non-grantor trust is a foreign trust that does not meet the definition of a foreign grantor trust. For U.S. federal tax purposes, a foreign non-grantor trust is treated as a separate taxpayer.

The following sections provide an overview of the U.S. tax treatment when income is retained in a foreign non-grantor trust and when it is distributed to a U.S. beneficiary.

Taxation of income retained in a foreign non-grantor trust

A foreign non-grantor trust is treated like a non-U.S. person for U.S. income tax purposes. When the income earned in the year is not distributed, the trust is only subject to U.S. income tax to the extent the income is U.S. source income or income effectively connected to a U.S. trade or business. U.S. tax may be levied by means of a withholding tax applied at source. Alternatively, the trust may be required to file a U.S. non-resident income tax return and pay tax on its U.S. source income at graduated tax rates. Note that the tax brackets are significantly

condensed for a trust as compared to those that apply to individuals, so the highest marginal tax rate is reached at a much lower taxable income level. If the trust has U.S. source business income, the trust could also be subject to state income tax, depending upon where the business income is derived.

Taxation of distributions to a U.S. beneficiary

When a distribution is made to a U.S. beneficiary of a foreign non-grantor trust, the tax treatment depends on whether the distribution represents "distributable net income (DNI)," "undistributed net income (UNI)" or capital. For U.S. tax purposes, distributions are always deemed to come first from DNI, then UNI, then capital on a pro rata annual basis. DNI is generally income earned in the trust in the year (with certain modifications) that is distributed in the same year to the trust beneficiaries and is subject to favourable U.S. tax treatment. Distributions of DNI retain their character in the hands of the beneficiary for U.S. tax purposes. UNI is generally accumulated income earned in prior years that is distributed in a future year. In contrast, UNI can be subject to punitive U.S. taxation.

After all income of the trust has been distributed to the beneficiary (including all amounts of DNI and UNI), further distributions of capital are not taxed.

A further discussion of these concepts is found in the following sections.

DNI

In general, all of the income earned by a foreign non-grantor trust in a year, with some modifications, is regarded as DNI. This includes tax-exempt interest income, net capital gains and foreign income earned by the trust. The DNI of a foreign non-grantor trust is calculated before deducting any amounts distributed to a trust beneficiary.

DNI for a trust tax year is generally treated as being distributed pro-rata among the trust beneficiaries. If a foreign non-grantor trust recognizes both capital gains and ordinary income in the same tax year, distributions to a U.S. beneficiary must include a proportionate share of both ordinary income and capital gains based on the relative inclusion of each type of income in DNI. The trust will get a deduction for the DNI distributed to its beneficiaries.

If the DNI is distributed to a U.S. beneficiary in the tax year, or within 65 days after the end of the tax year subject to a certain election, the income will retain its character and be taxable on the beneficiary's U.S. tax return. Since the income retains its character, the beneficiary will be able to benefit from preferential

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tax rates that apply to qualified dividends and long-term capital gains. Any DNI that represents tax-exempt interest income will be tax exempt in the hands of the U.S. beneficiary. Any foreign taxes withheld or paid by the trust on the distributed DNI may be claimed as a foreign tax credit by the U.S. beneficiary.

UNI and the throwback rules

When a trust doesn't distribute all of its DNI for the year, the excess is accumulated as the trust's UNI. When the trust makes a distribution, to the extent the amount of the distribution exceeds the trust's DNI for the year, the excess up to the UNI is subject to punitive U.S. tax treatment (referred to as the "throwback rules"). Any remaining balance in excess of the trust's UNI may be a tax-free capital distribution. A distribution of capital can only be made after all of the UNI has been distributed.

Distributions of UNI (also referred to as accumulation distributions) are subject to the throwback rules for a U.S. beneficiary. The throwback rules can result in punitive U.S. taxation. They are designed to trigger a tax that essentially recaptures the tax that would have been paid if the income had been distributed to the U.S. beneficiary in the year it was earned, rather than accumulated in the trust. The distribution is deemed to have been a payment of the earliest income accumulation. However, income paid out of UNI in a future year loses its character and is taxed as ordinary income rather than as long-term capital gains or qualified dividends. Furthermore, an interest charge is applied based on the tax on the accumulated income, similar to an underpayment penalty. The tax burden imposed by the throwback rules may potentially impose a significant amount of U.S. tax on the value of the accumulated distribution itself, which can be quite punitive. However, if the trust or the U.S. beneficiary paid foreign taxes on the distributed income at a high tax rate (such as Canadian income tax), the U.S. beneficiary can claim a foreign tax credit for those foreign income taxes on their U.S. tax return. If the foreign tax credit reduces or eliminates their U.S. taxes payable, the interest charge may be reduced or eliminated.

Since the taxable income of the trust may be computed differently for Canadian and U.S. tax purposes, the foreign tax credit may not be sufficient to eliminate the beneficiary's U.S. tax.

Distribution of capital

After all income (including realized capital gains) of the trust has been distributed to the beneficiary of a foreign non-grantor trust, further distributions of capital are not taxed, assuming the trust has fully distributed all accumulated income from prior years.

If a capital distribution is made from a foreign non-grantor trust in-kind, the property retains its adjusted cost base, unless an election is made by the trust to transfer the property at FMV and recognize the gain.

Other distributions

If property owned by a foreign trust is used by a U.S. grantor, U.S. beneficiary or any U.S. person related to them, and the consideration provided for the use is below the FMV attached to its use, the excess value is treated as a distribution to the U.S. grantor or U.S. beneficiary, unless the trust is paid the FMV for the use of the property within a reasonable time.

U.S. filing requirements for foreign trusts

In addition to regular U.S. income tax filing requirements, a U.S. person who is a grantor, beneficiary or trustee of a foreign trust may have additional reporting requirements. You should consult with a qualified cross-border advisor to determine what informational forms may be required to be filed with the U.S. tax authorities. These forms may result in additional tax preparation fees and significant penalties may be imposed by the U.S. tax authorities for the failure to file them.

Note that certain foreign trusts, such as tax-favored foreign retirement trusts, tax-favored foreign non-retirement trusts established for educational, medical and disability benefits and tax-favored foreign de minimis savings trusts, may be exempt from these additional informational reporting requirements if certain conditions are met. This does not mean, however, that these trusts are exempt from the payment of U.S. income taxes.

Other tax implications

U.S. gift and estate tax

The U.S. transfer tax system includes a U.S. gift tax, estate tax and generation skipping transfer tax. For more information on U.S. transfer taxes, ask your RBC advisor for an article on this topic. If you transfer property to a foreign trust, depending on your status as a U.S. person and the nature of the assets transferred, you may be subject to U.S. gift tax unless you have not given up "dominion and control over the property" (e.g. the power to dispose of trust property or the power to revest beneficial title to the property). If you were not subject to U.S. gift tax because you maintained dominion and control over the trust property, gift tax may be triggered when the property is subsequently transferred from the trust to someone else.

Exposure to U.S. estate tax on property held in a foreign trust can result from having a "retained interest" in the property transferred to a foreign trust (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). It can also result from having a "general power of appointment" as a beneficiary of the trust. A general power of appointment exists where, as a beneficiary, you have the power to direct the trust property to anyone, including yourself, your creditors, your heirs or the creditors of your estate. A holder of a general power of appointment is treated as the owner of the property that is subject to the power, whether or not the power is actually exercised.

Gain recognition on transfers of property to a foreign trust

In addition to possible U.S. gift tax, a transfer of appreciated property by a U.S. person to a foreign non-grantor trust is treated as a sale or exchange at FMV. The U.S. person recognizes a gain and is subject to U.S. income tax on the transfer. A loss cannot be claimed on property that is transferred to a foreign non-grantor trust and is in a loss position. Regardless of whether the property has accrued gains or losses, U.S. gift tax may still apply to the FMV of the property transferred to the trust.

These rules generally do not apply in the case of a transfer of appreciated property by a U.S. person to a foreign grantor trust.

Investments by foreign trusts in foreign corporations

The U.S. has anti-deferral tax regimes, including the controlled foreign corporation (CFC) rules and the passive foreign investment company (PFIC) rules. Under these rules, certain income of a foreign corporation may be included in the income of a U.S. person who owns an interest in the corporation, even if an actual distribution has not been made. As well, when a distribution is made from certain foreign corporations, punitive U.S. tax may apply. These tax regimes primarily apply to U.S. persons who have a direct or indirect ownership of the stock of a foreign corporation; however, they also contain attribution of ownership rules that apply to U.S. beneficiaries of a foreign trust. For these purposes, stock directly or indirectly owned by the trust may be treated as being owned proportionally by the beneficiaries of the trust. This means a U.S. beneficiary may be subject to the tax and reporting requirements that apply under these anti-deferral tax regimes. For more information on the PFIC rules, speak to a qualified cross-border tax advisor.

Summary

Trusts are commonly used as part of a Canadian resident's tax and estate plans. However, many of the typical strategies involving the use of trusts may be ineffective where a U.S. person is involved with a Canadian trust. The U.S. tax implications for the U.S. person must also be considered. Differences in the Canadian and U.S. tax treatment of the Canadian trust could result in a mismatch in the timing of the income recognition and the entity or individual subject to tax in each country, potentially resulting in double taxation in certain situations. Income earned in a foreign trust may also be subject to punitive U.S. tax treatment. As well, a U.S. person who is connected to a foreign trust may be subject to additional reporting requirements.

It is therefore important to seek advice from a qualified cross-border tax advisor before setting up a trust that involves a U.S. person. This may ensure that your desired tax and estate planning goals are achieved and minimize the possibility of an unexpected tax surprise.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.



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