TAX FUNDAMENTALS FOR THE ESTATE PRACTITIONER

THE CASE OF THE COMPLICATED CHILDREN

Overview

Disabled Beneficiaries
Other "Vulnerable" Beneficiaries
U.S. Citizen Beneficiaries
Non-Resident Beneficiaries Generally

First Things First

Who is the Client?

- Child looking for advice to ensure an efficient and appropriate plan is put in place for himself / herself

  OR

- Parent wanting to ensure the estate plan accomplishes their goals and assets are passed in the best way possible, as they determine
- Regardless, the other party may need to sign documents or otherwise be involved. Make sure the parties understand who you are acting for and others retain independent legal advice, if needed.
- May need to involve the child's representative (i.e., committee, attorney, section 7 representative)

Disabled Beneficiaries

CLE BC

Disabled Beneficiaries

- A beneficiary may qualify for benefits (now or in the future) and want to ensure any inheritance received does not jeopardize their entitlement
- Discussing only benefits available in B.C., and more specifically trust planning for B.C. persons with disabilities
- Rules in other provinces can be drastically different
- If outside of B.C., need local counsel

CLE BC

Disabled Beneficiaries

- Review the current legislation
- In B.C., *Employment and Assistance for Persons with Disabilities Act* ("EAPDA") and the related regulations
  - Recent changes as of 2015
- The Trust Policy of the Ministry of Social Development and Poverty Reduction ("**SDPR**")

Disabled Beneficiaries

- Asset Test
  - $100,000 threshold for a single individual, or a couple or family where only one person has a person with disabilities ("**PWD**") designation
  - $200,000 for a couple where both adults have the PWD designation
- If in excess of the relevant threshold, benefits are lost for the month that the funds are received and every month after that until below the threshold again.
- "Exempt assets" not counted toward the threshold: clothing, household equipment, a motor vehicle, a place of residence, Canada Child tax benefit, assets held within an RDSP, and assets held in certain qualifying trusts.
- An asset received by a PWD that is contributed to a trust or an RDSP within 3 months of its receipt is treated as exempt.

Disabled Beneficiaries

- Income Test
  - Threshold depends on characteristics of the PWD, i.e. a single person with a disability can earn up to $9,600/year without losing eligibility for assistance.
  - Considers both earned and unearned income. Unearned income includes "money or value" received from a trust.
- If income limits are exceeded in a month, disability benefit reduced for that period dollar for dollar.
- Certain income exempt, such as child support payments, moneys withdrawn from an RESP or RDSP, as well as education, training allowances, and scholarships. In addition, certain cash gifts and inheritances.
- Trust payments are exempt provided payments out of a trust are to or for the benefit of the PWD for disability-related costs, the acquisition of a family unit's place of residence, an RDSP or an RESP.

Disabled Beneficiaries

- Trust Planning
  - Effective for tax planning as well as general estate planning
  - SDPR publishes Trust Policy found at www.eia.gov.bc.ca/publicat/pdf/DisabilitiesTrusts.pdf.
  - The Trust Policy is neither legislation nor regulatory
  - Can be changed at the discretion of the Minister
- Two types of trusts: "discretionary trusts" and "non-discretionary trusts"
  - Distinction relating to the power and control, or lack thereof, each of the trustee and the beneficiary have in managing the assets of and administering the trust.

Disabled Beneficiaries

- Non-Discretionary Trusts
  - Trustee does not have exclusive discretion over how assets are managed, beneficiary may have some input.
  - Trust Policy does not specify what control on the part of a beneficiary would make a trust non-discretionary.
  - Considered an exempt asset, so long as the capital contributed does not exceed $200,000, or if in excess then special approval must be given by the Minister.
  - Should be reviewed by the Legislation and Litigation Branch in Victoria.

Disabled Beneficiaries

- Discretionary Trusts
  - "Henson trusts"
  - Generally not considered an asset and therefore no limit to amount of money held.
  - Under Trust Policy, a discretionary trust under which the PWD can access capital unilaterally (ex. sole trustee or without consultation with co-trustee) treated the same as a non-discretionary trust.
  - *S.A. v. Metro Vancouver, Housing Corp.*, 2019 SCC 4 ("**MVHC**")
    - Two essential features of a Henson Trust are that the trust terms (1) do not confer any fixed entitlements on the beneficiary; the trustee has the ultimate and absolute discretion over whether to make any payments out of the trust; and (2) prevents the beneficiary from terminating the trust on his or her own.
    - Particular Henson trust in MVHC **not** an asset, but Court made clear this was factual analysis and some Henson trusts, depending on the program involved, may be treated as an "asset.

Disabled Beneficiaries

- Testamentary Trusts
  - A trust or estate that is created on and as result of the death of the person to which no one other than the deceased has contributed property.
  - Does not include a life interest trust or a subtrust created from a life interest trust.
- If PWD qualifies for disability tax credit ("**DTC**"), should also consider ensuring the trust is a "qualified disability trust" (a "**QDT**"). Access to graduated tax rates. Potential access to principal residence exemption.
- To qualify as a QDT...
  - The trust must be a testamentary trust that arose on and as a consequence of an individual's death.
  - The trust must be resident in Canada for the year.
  - The trust must include in its tax return for the year:
    - A joint election with one or more beneficiaries to be a QDT for the year;
    - The SIN of each electing beneficiary;
    - Each electing beneficiary is an individual named as a beneficiary under the trust, qualifies for the DTC, and has not elected with any other trust to make that trust a QDT.

Disabled Beneficiaries

- *Inter Vivos* Trusts
  - Created during the settlor's lifetime, either by the PWD, or by a friend or family member wishing to benefit the PWD.
- Consideration to section 75(2)
- Taxed at highest marginal tax rate and no eligibility for principal residence exemption.

Other “Vulnerable” Beneficiaries

Other “Vulnerable” Beneficiaries

- Not entitled to benefits under the EAPDA, but for whatever reason cannot manage his or her own financial affairs, or perhaps a beneficiary who is subject to potential negative influence.
- Trust planning is crucial, as often the goal is to ensure the trust funds last throughout the beneficiary’s lifetime.

Other "Vulnerable" Beneficiaries

- If not a QDT, income not paid or payable to a beneficiary will be taxed at the highest marginal tax rate.
- Payments of income can be made directly to third party providers.
- Alternatively, if appropriate, draft provisions to provide the beneficiary with a set income stream; capital remains protected.
- Another option is to expressly provide that the Trustee should consider an investment strategy focused on growth instead of income, coupled with a waiver of the even-handed principle.

Other "Vulnerable" Beneficiaries

- Purchasing a principal residence for the beneficiary?
  - Capital gains on a later disposition likely will not be eligible for the principal residence exemption.
  - Tax savings may be outweighed by the advisability of having the residence owned by the trust.
- Where appropriate, consider including provisions for loans to beneficiaries so that the residence can be purchased by the beneficiary directly instead of by the trust.

U.S. Citizen Beneficiaries

U.S. Citizen Beneficiaries

- U.S. citizens, green card holders, and residents are subject to U.S. income tax on their worldwide income
- U.S. citizens and domiciliaries are subject to U.S. transfer taxes on their worldwide transfers of assets
- As a result, where a child is a U.S. citizen, even if resident in Canada, traditional Canadian trust planning can have unintended tax consequences.

U.S. Citizen Beneficiaries

- U.S. Estate Tax
  - U.S. Estate Tax Exemption now USD$11,400,000 per person with a top rate of 40% in excess of that
  - Scheduled to return to the USD$5,000,000 adjusted for inflation in 2026
  - Want to ensure assets passing to or held for benefit of U.S. beneficiary don't unnecessarily increase the beneficiary's estate and result in (additional) U.S. estate tax

U.S. Citizen Beneficiaries

- Consider creating a properly structured U.S. estate tax protected trust where U.S. beneficiary's right to receive distributions is limited
- A trust created by a non-resident alien ("NRA") of the U.S. can be a "dynasty trust", avoiding U.S. taxes as long as the rule of perpetuities allows
- Trusts can be created in Will or *inter vivos* trusts for maximum perpetuity period for benefit of U.S. citizen and resident beneficiaries

U.S. Citizen Beneficiaries

- *Inter Vivos* Trust Planning for the Canadian Settlor with U.S. Beneficiaries
  - Provided the trust is not funded with U.S. situs assets, unlimited opportunity
  - Grantor trust to the NRA if structured appropriately
  - Cautious of Section 678 of the Internal Revenue Code
- If beneficiary is resident in the U.S.
  - TOSI rules do not
  - If structured properly, only tax owing is a 15% Canadian withholding tax rate

U.S. Citizen Beneficiaries

- On Grantor's death, or if created as a testamentary trust...
  - Non-grantor trust
  - "Throwback rules" apply, as well as attribution of underlying trust property
    - Move jurisdiction of the trust to the U.S. on settlor's death, if possible, and obtain local U.S. State counsel advisable
    - Otherwise, to avoid throwback, all accumulated income and realized capital gains must be distributed in the calendar year prior to making distributions to U.S. beneficiary

U.S. Citizen Beneficiaries

- When a U.S. person has a direct or indirect interest in a non-U.S. corporation, the U.S. anti-deferral tax rules apply. This includes an interest through a non-grantor trust (however, not a grantor trust).
- Two regimes to consider: "controlled foreign corporation" ("CFC") or "passive foreign investment corporation" ("PFIC") rules

U.S. Citizen Beneficiaries

- A non-U.S. corporation is a CFC if "U.S. Shareholders" hold more than 50% of the votes or value of the particular corporation
- A person is a "U.S. Shareholder" if the person is a U.S. citizen or resident (including an entity) and holds 10% of the votes or value of the particular corporation
- U.S. Shareholders of a CFC are subject to current tax on Subpart F Income (broadly, passive or deemed passive income). Passive can include rental income and professional services income.

U.S. Citizen Beneficiaries

- To determine whether ownership of a non-U.S. corporation results in application of the CFC rules, beneficiaries of any estate or trust are deemed to own shares held by estate or trust
- Grantor Trust
  - Taxed as owned by a person who made a gratuitous transfer to the trust.
  - Narrow circumstances in which a non-U.S. person can be taxed as the owner
  - No U.S. tax to the beneficiary during the lifetime of the "grantor" and no attribution of the trust's assets (CFC and PFIC status can be avoided)
- Where Non-Grantor Trust status applies, the beneficiaries are treated as having a proportionate interest in the trust. No guidance for a discretionary trust. General consensus is consideration to the pattern of distributions.

U.S. Citizen Beneficiaries

- If not a CFC, consideration of PFIC rules.
- Non-U.S. corporation is a PFIC if >75% of gross income is passive; or >50% of assets generate passive income.
- Interest and historical rates on distributions of accumulated income
- Very generally, an excess distribution is the excess of the distributions received from the corporation during the taxable year, over 125% of the average of the distributions received by the shareholder for the preceding three taxable years

U.S. Citizen Beneficiaries

- PFIC stock is attributed from a non-grantor trust to its beneficiaries "proportionately."
- No guidance.
- Temporary regulations provide that in making this determination, all the facts and circumstances must be taken into account.
- As with the CFC rules, one factor that has been used in the past is the pattern of past distributions.

Non-Resident Beneficiaries Generally

Non-Resident Beneficiaries Generally

- 25% withholding tax on distributions of most income
- Part XII.2 Tax
- Appreciated assets of a trust other than Canadian real property do not roll out to non-resident beneficiaries. The trust is deemed to have disposed of asset for fair market value.
- Section 116

Non-Resident Beneficiaries Generally

- Consider local tax rules, could result in double taxation
- Tax may be levied on the client, the estate, or even the beneficiary receiving the assets.
- Can depend on the citizenship, residence, and domicile of the client/donor or the recipient-child as well as the location of the asset being given.
- Retain local counsel

Non-Resident Beneficiaries Generally

- A few examples of this…
  - France
  - Belgium
  - The Netherlands

Questions?

Thank you!

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