Heir Un-apparent: Estate Planning for U.S. Beneficiaries

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Estate planning involves consideration of who should benefit from your assets and when. If your heirs are U.S. persons, Uncle Sam may lay claim to a portion of what they inherit from you, since the U.S. estate and gift tax regime may erode a part of the wealth that your heirs could otherwise pass along to their own beneficiaries. With planning, however, you may be able to help your heirs preserve family wealth for future generations.

U.S. Taxes May Affect U.S. Beneficiaries of Your Canadian Estate

Individuals who are "U.S. persons" must file and pay tax in the United States, regardless of where they actually live.

For U.S. federal income tax and reporting purposes, U.S. persons generally include U.S. citizens and individuals who hold a U.S. green card, as well as individuals who have been present in the United States for a substantial period of time.[1]

For purposes of the U.S. federal estate tax, gift tax and generation-skipping transfer tax ("GSTT," discussed below), U.S. persons are individuals who have U.S. domicile. Such individuals have indicated or demonstrated, in the view of the Internal Revenue Service (IRS), an intention to make the U.S. their permanent home, and generally include U.S. citizens and individuals who hold a U.S. green card.

Assuming that you are not a U.S. person, U.S. taxes and reporting will not affect you or your estate if you do not have any assets situated in the United States, often referred to as "U.S situs property." If you leave your assets to someone who is a U.S. person, however, then U.S. estate and transfer taxes could impact the value of the assets that your beneficiaries (and future generations) are able to retain.

To illustrate, suppose you are a Canadian resident (and not a U.S. citizen) and the sole beneficiary of your US$30 million estate is your daughter, who is a U.S. citizen and lives permanently in Florida. Let's look at some of the issues that could impact your daughter.

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1 For 2019, an individual is generally a U.S. resident under the "substantial presence test" if the individual has been present in the U.S. for at least 31 days in 2019, and for at least 183 days over a three-year period, calculated as the total of: all of the days in 2019; 1/3 of the days in 2018; and 1/6 of the days in 2017. Some exceptions apply. Additional information is available on the IRS website at http://www.irs.gov/Individuals/International-Taxpayers/The-Green-Card-Test-and-the-Substantial-Presence-Test.

Issue 1: U.S. Estate Tax, Gift Tax and GSTT

While your own Canadian estate may not be subject to any U.S. taxes upon death, your daughter's worldwide estate is affected by U.S. estate tax since she is a U.S. person. The U.S. has a federal estate tax that is levied on the worldwide estate of a U.S. person upon death. In 2019, U.S. federal estate tax is imposed on the fair market value (FMV) of assets at graduated rates ranging from 18% to 40%. There is a federal estate tax exemption that may eliminate this tax if the worldwide estate value is not more than US$11.4 million in 2019.[2] Larger estates, however, may be eroded by U.S. estate tax.

A U.S. person generally cannot avoid estate tax merely by gifting assets away before death, since there is a federal gift tax that is integrated with the U.S. estate tax. U.S. persons must pay gift tax on the FMV of most gifts, with the following exceptions in 2019:

- Up to US$11.4 million of gifts during lifetime, which reduces the available estate tax exemption;
- Unlimited gifts to a U.S. spouse (since the spouse will pay estate tax upon death);
- US$155,000 of gifts annually to a non-US spouse; and
- US$15,000 of gifts annually to each other recipient.

Furthermore, if a U.S. person makes a gift or leaves a bequest to an individual who is more than one generation younger, then GSTT equal to 40% of the FMV of the gift will be added to the estate or gift tax bill in 2019.

In addition to these federal taxes, several U.S. states have their own estate and/or inheritance taxes.

The Impact of Federal Estate Tax on Future Generations

Figure 1 shows the impact federal estate taxes may have on wealth that is available for future generations after your daughter inherits your $30 million estate.

Figure 1: Successive Estate Erosion by U.S. Estate Tax

Family Member	Amount Available to Family Member (US$)	Estate Tax[3] (US$)	Amount Available to Beneficiaries After Estate Tax (US$)
You	30,000,000	0	30,000,000
Your daughter	30,000,000	(7,440,000)	22,560,000
Your grandchildren	22,560,000	(4,464,000)	18,096,000

Suppose your daughter does not spend any of the amount that she inherits from you and she has a gross estate of US$30 million upon her death. If she leaves all her assets to her son (your grandson), her federal estate tax bill will be US$7.44 million.[4] Consequently, your grandson will inherit only US$22.56 million of your original US$30 million estate. If your grandson leaves his US$22.56 million estate to his children (your great-grandchildren), his federal estate tax bill will be about US$4.464 million. Consequently, your great-grandchildren may inherit only about US$18 million, which translates to only about 60% of your original $30 million estate (ignoring any future growth/decline in the value of your original estate.) In other words, in just

[2] Married residents may be eligible to claim the marital credit, which may eliminate federal estate tax if the total value of a couple's estate does not exceed US$22.8 million in 2019.

[3] In December 2017, President Trump passed the Tax Cuts and Jobs Act (TCJA) that temporarily doubled the estate tax exemption (which is indexed to inflation annually) for years from 2018 and 2025. The doubled exemption is slated to expire after 2025, which would significantly increase estate taxes for estates that exceed the exemption amount. Estate taxes have been calculated using 2019 estate tax rates (which range from 18% to 40%) and the 2019 exemption amount of US$11.4 million.

[4] Using 2019 rates. Impact of any marital credit your daughter may or may not be entitled to in the future has not been considered.

two generations, over one-third of your original $30 million estate would be eroded by federal estate taxes and would not be available to benefit future generations.

Issue 2: U.S. Reporting

From a U.S. tax perspective, your Canadian estate is a foreign estate. As a result, certain U.S. reporting forms may need to be filed.

For example, the estate representative may need to file Form *3520-A, Annual Information Return of Foreign Trust With a U.S. Owner*. Your daughter may have to file Form *3520, Annual Return To Report Transactions With Foreign Trusts*. Also, if your daughter has a financial interest in non-U.S. financial accounts (which includes the non-U.S. accounts in your estate[5]) totaling at least US$10,000, your daughter must disclose the accounts annually to the U.S. Department of Treasury by electronically filing a Financial Crimes Enforcement Network (FinCEN) Form *114, Report of Foreign Bank and Financial Accounts* (FBAR). And, depending on the fair market value of your daughter's interest in your non-U.S. estate, your daughter may also need to file Form *8938, Statement of Specified Foreign Financial Assets*.

Compliance with these reporting requirements may be quite costly. The forms are complex and, if your daughter or the estate representative need professional assistance to complete them, annual fees may range from hundreds to thousands of dollars. Non-compliance, however, is likely to be even more costly. The penalties for failing to file start at US$10,000 per occurrence and, if non-compliance is willful or fraudulent, the penalty may be as much as 50% of foreign account balances.

A Solution: Dynasty Trusts

Rather than leaving your assets directly to U.S. beneficiaries, it may be preferable to create what's often referred to as a "dynasty trust," which is a trust arrangement designed mainly to prevent U.S. estate tax erosion of family wealth. Assets held in a dynasty trust are not owned by the trust beneficiaries and, therefore, are not subject to estate tax, gift tax, or generation-skipping transfer tax in the hands of beneficiaries.

To create a dynasty trust, you would transfer your assets, either during your lifetime or under your will, to a trustee who will manage the assets in accordance with the terms of the trust on behalf of the U.S. beneficiaries. Once you have transferred the assets, you will no longer have control or use of the assets, which is why some people prefer to create trusts upon death; however, transferring assets to a trust during your lifetime may also help to avoid probate fees that would apply to your estate upon death.

A dynasty trust may have multiple beneficiaries, who may include individuals who are not yet born (such as future children and descendants), or a class of beneficiaries (such as grandchildren). This permits flexibility to include future beneficiaries. This is particularly useful when the trust is established in a jurisdiction that allows trusts to continue in perpetuity, with no end date[6].

Dynasty trusts are designed with certain restrictions so that the beneficiaries do not control the trust assets. These restrictions help to prevent the trust assets from being included in a beneficiary's taxable estate upon death. Beneficiaries may, however, be given certain limited powers over distributions. For example, a beneficiary may have the power to compel the trustee to distribute funds for the beneficiary's health, education, support or maintenance, within "ascertainable standards." A beneficiary may also have the power to compel the trustee to distribute, annually, 5% of trust assets or US$5,000, whichever is greater.

Assets that are distributed from the trust to a beneficiary may be subject to gift tax (if the beneficiary subsequently gifts the assets), estate tax (if the beneficiary holds the assets upon death) or GSTT (if the

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[5] Your daughter would be considered to have a financial interest in the accounts of your estate since she would have a greater than 50% present beneficial interest in the assets or income of the estate.

[6] Typically, the dynasty trust is created within the jurisdiction of a U.S. state. In such circumstances, the Canadian non-resident trust rules should also be evaluated for their impact on the benefit of using a dynasty trust.

beneficiary transfers the assets to someone who is more than one generation younger). Limiting a beneficiary's powers over distributions may help reduce the assets that are accumulated by a beneficiary and may be subject to these taxes.

The trustee has a fiduciary responsibility to manage the assets for the benefit of all beneficiaries (current and future) in accordance with the terms that you include in the trust agreement. The terms may dictate specifically how the trustee should manage the assets and make distributions. Alternatively, the trustee may be given discretion to make some or all decisions. Often trustees are given broad discretion and, if beneficiaries are not given any powers over distributions, the trustee may choose not to make any distributions to beneficiaries who do not need the funds so wealth may accumulate for future generations.

Choosing a Trustee

A trustee has many responsibilities, including managing the trust property, making payments to beneficiaries, maintaining financial records, and filing tax returns and reporting forms. When the trustee has discretion as to distributions, the trustee must also determine the proper amount, timing and type of distributions, considering the interests of all beneficiaries, who may have competing interests in trust income and capital.

Given the numerous responsibilities, it is crucial to choose a trustee who has the skill, time and knowledge to properly administer the trust. While a family member or friend is often considered as trustee, these individuals may not be qualified or prepared to effectively handle all the requirements, particularly given that a dynasty trust may last well beyond the lifetime of an individual trustee.

It may, therefore, be beneficial to name a corporate trustee who has experience in the various aspects of managing and administering trusts and who may survive in perpetuity. Also, by being independent of family members, a corporate trustee can make decisions objectively, which can be particularly beneficial if there is family conflict. Because of U.S. tax and reporting issues that may arise with a Canadian trust, it may be advisable to have a U.S. dynasty trust[7]. Appointing CIBC Bank USA, a U.S. trust company, as the corporate trustee of your dynasty trust may help to give you peace of mind that your wealth will benefit many future generations as you intend.

Due to the complexities involved, you should consult Canadian and U.S. tax and legal advisors prior to implementing a dynasty trust, either during your lifetime or under the terms of your will.

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[7] For a U.S. dynasty trust, a court within the United States must be able to exercise primary supervision over the administration of the trust (court test); and one or more United States persons must have the authority to control all substantial decisions of the trust (control test).

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As with all planning strategies, you should seek the advice of a qualified tax advisor.