Bloomberg BNA

Tax Management
International Journal™

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Twenty-One Years Is Not Enough: Avoiding Canada's 21-Year Rule with Trusts for U.S. Beneficiaries

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Of the many challenges to cross-border planning, perhaps none is as organic as the inconvenient differences between the revenue laws of different countries. In fact, tax results on one side of a border can be downright incompatible with those on the other side. An example of this is the treatment afforded gratuitous inter vivos transfers of appreciated property under the revenue laws of the United States and Canada. Not surprisingly, both countries' current tax systems subject inter vivos transfers of appreciated property to taxation. Such gratuitous transfers are a deemed disposition under the Income Tax Act (ITA), subjecting the unrealized gain in transferred property to a capital gains tax based upon the difference between the transferor's basis and the fair market value of the transferred property.[1] Somewhat similarly, the United States also taxes transfers of wealth, subjecting inter vivos transfers of appreciated (and non-appreciated) assets to a gift tax based upon the entire fair market value of the transferred property. The revenue laws of both countries have also anticipated efforts of tax advisors to circumvent future taxation of a subsequent transfer by the recipient of the original gift. In the case of the United States, trusts with multiple generations of beneficiaries are subject to a generation-skipping transfer tax.[2] In the case of Canada, assets held in trust are subject to a deemed disposition every 21 years under section 104 of the ITA.[3]

The provisions of chapter 13 of the Internal Revenue Code (I.R.C.) subject generation-skipping transfers to a generation-skipping transfer tax imposed at the highest marginal U.S. estate tax rate.[4] U.S. citizens and non-citizens who are domiciled in the United States (''U.S. persons'') who make a generation-skipping transfer have a $5 million generation-skipping transfer tax exemption (indexed to $5.49 million for transfers occurring in 2017) to shelter such transfers from the generation-skipping transfer tax. By reliance on the GST exemption, U.S. persons can establish ''dynasty trusts'' which enable assets to be permanently removed from the U.S. gift, estate, and generation-skipping transfer tax systems (subject to perpetuities rule limitations of the jurisdiction in which the trust is resident). In fact, for both asset protection and transfer tax purposes, dynasty trusts are the prevailing motif and solution in U.S. planning for intergenerational transfers of wealth. Generations of family members can cycle through as beneficiaries of the dynasty trust without subjecting the trust assets to any U.S. transfer tax.

Residents of Canada (whether U.S. citizens or not) may wish to utilize dynasty trusts in planning for U.S. persons who will receive inter vivos or testamentary transfers of wealth. However, often the cost of doing so is that under the provisions of the ITA the assets of the dynasty trust will be marked to market and subjected to a capital gains tax on unrealized appreciation every 21 years. This result is most unfortunate in that a non-U.S. citizen domiciled in Canada is not subject to the limitations imposed on U.S. persons transferring assets to a generation-skipping trust. U.S. persons transferring wealth to a dynasty trust are able to do so on a tax-free basis only to the extent the available gift

[1] Income Tax Act (''ITA'') §73(1).

[2] Internal Revenue Code (''I.R.C.'') §2601 *et seq*.

[3] *See* ITA §104(4).

[4] I.R.C. §2641(a)(1).

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ISSN 0090-4600

and estate tax exemption of such an individual has not previously been exhausted (a $5 million cumulative amount, indexed to $5.49 million for inter vivos or testamentary transfers occurring in 2017). In contrast, a non-U.S. person has no U.S. gift tax exposure for inter vivos or testamentary transfers of wealth so long as the transferred assets do not involve tangible property (real or personal) physically present in the United States or, in the case of testamentary transfers, certain intangibles such as shares of U.S. corporations or debt obligations of U.S. persons, as well.[5]

Although a non-U.S. person escapes U.S. gift or estate taxation on transfers of assets to a dynasty trust, assets with unrealized gains are subject to a deemed disposition when transferred by a settlor resident in Canada to a dynasty trust, subjecting the unrealized gain to a Canadian capital gains tax. However, transfers of non-appreciated assets escape this fate. Cash and other assets not subject to appreciation may be transferred to a dynasty trust without triggering a tax in Canada. Further, in the case of a Canadian resident decedent, death itself is a disposition such that the assets of the decedent receive a basis adjustment to fair market value. The dynasty trust can be funded on a testamentary basis without further incidence of Canadian taxation.

The ITA deems most personal trusts (including dynasty trusts) ''to have disposed of each property of the trust (other than exempt property) that was capital property. . .or land included in the inventory of a business of the trust for proceeds equal to its fair market value. . .at the end of that day'' which is 21 years after the date the trust was created and every 21 years thereafter.[6] This feature of the ITA is commonly referred to as ''21-year rule.'' The recognition event is deemed to include not just unrealized gains but also accrued income attributable to the property.[7] The trust is deemed to have reacquired the property subject to the 21-year rule at a cost equal to the fair market value by which gain on the deemed disposition was computed. Thus, the property subject to the deemed disposition receives a cost basis for computing future gain or loss equal to the property's fair market value on the date each disposition is deemed to have occurred. The adverse effect of the 21-year rule can easily be avoided by distributing assets to the trust beneficiaries prior to the 21st anniversary of the trust. However, such a distribution defeats the asset protection and U.S. transfer tax benefits of the dynasty trust. Consequently, the effect of the 21-year rule is to require accrued income and gains to be recognized either at the death of the trust beneficiaries to whom assets are distributed or every 21 years in the case of assets retained in the trust.

Careful reading of the provisions of the ITA reveals a path by which trustees and beneficiaries of dynasty trusts established by Canadian residents for the benefit of U.S. persons will avoid Canadian taxation of trust income and gains, including deemed dispositions under the 21-year rule. The 21-year rule applies to both resident and non-resident trusts. However, because of the exception for exempt property, the 21-year rule applies only to taxable Canadian property (generally real property situated in Canada including shares of a corporation if more than 50% of the fair market value of the shares is derived directly or indirectly from real property situated in Canada). The term ''exempt property'' is defined as property not subject to tax under the revenue laws of Canada ''because the taxpayer is non-resident or because of a provision contained in a tax treaty. . . .''[8] Consequently, if a trust is not resident in Canada, the 21-year rule applies only to property otherwise subject to Canadian tax on its disposition even if owned by a non-resident (''taxable Canadian property''). Accordingly, if a Canadian resident (whether or not the individual is a citizen of the United States) establishes a non-resident trust, the 21-year rule applies only to taxable Canadian property. Broadly defined, the term ''taxable Canadian property'' refers to direct or indirect interests in real property situated in Canada, as well as interests in Canadian resource properties and limber resource properties.[9] However, the definition of ''exempt property'' under the ITA further limits property subject to the 21-year rule when a tax treaty provides relief. Under Article XIII of the Convention Between Canada and the United States with Respect to Taxes on Income and on Capital (the ''Tax Treaty'') a U.S. resident is generally only taxable on gains derived from sale of real property situated in Canada, shares of the capital stock of a company resident in Canada whose value is derived ''principally from real property situated in Canada,'' and interests in partnerships, trusts, or estates, the value of which is derived ''principally from real property situated in Canada.''[10]

Unlike the objective test of trust residence provided by I.R.C. §7701(a)(31)(B), residence of a trust for Canadian tax purposes is determined on the basis of management and control — that is, the location where management and control of the trust is exercised by

[5] *See* I.R.C. §2104, §2501(a)(2).

[6] ITA §104(4).

[7] *See* ITA §140(5)–(5.2).

[8] ITA §108(1), definition of ''exempt property.''

[9] *See* ITA §248(1), definition of ''taxable Canadian property.''

[10] Tax Treaty Article XIII, ¶3(b).

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ISSN 0090-4600

its trustees.[11] However, even if management and control of the trust is centralized outside of Canada, the provisions of ITA §94 may nonetheless deem a non-resident trust to be resident in Canada. This occurs if either of two tests are satisfied:

(1) there is a Canadian resident contributor, or

(2) there is a Canadian resident beneficiary.

In the case of trust established by a Canadian resident settlor or decedent for the exclusive benefit of U.S. persons who are not resident in Canada, the second test will never be met. An individual must have ''sojourned'' in Canada for more than 182 days during a calendar year to be regarded as a resident for Canadian tax purposes.[12] If the U.S. beneficiaries of the trust are not regarded as resident in Canada under the terms of the ITA, the definition of a ''resident beneficiary'' in ITA §94(1) cannot be satisfied.

Although the resident beneficiary test of ITA §94(1) is not satisfied, a non-resident trust may nonetheless be deemed resident if the resident contributor test is satisfied. The ITA defines the term ''resident contributor'' as ''a person that is, at that time, resident in Canada and a contributor to the trust. . . .''[13] An individual who settles a trust before becoming a Canadian resident will nonetheless be regarded as a resident contributor once that individual becomes resident in Canada. However, a contributor once deceased is no longer regarded as a resident contributor.[14]

[11] *See Fundy Settlement*, 2012 SCC 14, *aff'g St. Michael Tr. Corp. v. The Queen*, 2010 FCA 309, and *Garron et al. v. The Queen*, 2009 TCC 450.

[12] *See* ITA §250(1).

[13] ITA §94(1), definition of ''resident contributor.''

[14] *See* ITA §94(5).

CONCLUSION

Non-resident trusts settled by Canadian residents will not be subject to the 21-year rule unless the trust holds property subject to taxation by Canada under the provisions of the Tax Treaty. Although the Canadian resident settlor may be taxable on the transfer of assets to the trust as a disposition, no realization or recognition event will occur unless there is unrealized income or gain in the property with which the trust is settled. Because of the basis adjustment to the decedent's assets as a result of the decedent's death, little or no gain should be recognized on funding the trust with those assets (whether owned directly or indirectly through an alter ego or joint partner trust). The trust will not be deemed resident in Canada if the persons exercising control and management of the trust assets are not resident in Canada and if trust beneficiaries are limited to U.S. persons and the Canadian resident settlor is no longer alive. Consequently, a dynasty trust settled by a Canadian resident who is deceased will be subject to Canadian income taxation in general and the 21-year rule in particular only if the trust holds taxable Canadian property. If the trust is regarded as U.S. resident under the provisions of the Tax Treaty, Article XIII limits the taxable Canadian property subject to income taxation and the 21-year rule to real property situated in Canada owned directly or indirectly by the trust. Consequently residents of Canada are able to settle dynasty trusts for the benefit of U.S. family members that will be exempt from Canadian income taxation, including taxation of unrealized gain under the 21-year rule, for most assets in which trust corpus is invested.

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ISSN 0090-4600