CROSS-BORDER BENEFICIARY DISTRIBUTIONS — A SHORT HISTORY OF NEARLY EVERYTHING TAX

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1. Introduction

Most trustees and estates practitioners are familiar with the tax issues related to the administration of a Canadian trust having Canadian beneficiaries. The mechanics of accounting and reporting for the distribution of trust income and capital at the trust level and the corresponding receipt of such distributions by the beneficiaries are relatively standard. However, in these times of global mobility it has become increasingly common to encounter domestic trusts having one or more foreign beneficiaries, or to list as clients individuals holding beneficial interests in foreign trusts.

While it is likely unrealistic to develop proficiency in the laws of multiple jurisdictions, in order to remain relevant (and perhaps to avoid litigation) trustees and practitioners should make themselves familiar with the fundamental issues related to cross-border beneficiary distributions. It can be argued, and likely will be, that the obligation of a trustee to consider the tax position of each beneficiary does not stop at the border. A requirement that the trustee obtain tax advice from local counsel or, at minimum, alert the beneficiaries to the existence of potential issues does not seem unreasonable.

This paper will attempt to spotlight some of the tax issues that should be considered when a trust resident in either Canada or the U.S. makes a distribution to a beneficiary resident in the other jurisdiction. While there are a myriad of technical issues that must be considered, the scope of this paper is necessarily limited to providing a basic guide to the primary concerns.

The paper will begin with a brief discussion of how the residency of the trust is determined. That will be followed by a review of the primary anti-avoidance and anti-deferral legislation that operates to subject the income of a trust, wherever resident, to taxation in the legislating country. The paper will then review the theory and mechanics governing distributions from Canadian trusts to U.S.

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beneficiaries and will finish with a brief consideration of issues related to distributions from U.S. trusts to Canadian beneficiaries.

A number of assumptions will be made unless otherwise stated. Firstly, that the beneficiaries are resident in and citizens of only one country; secondly, that the trusts are resident in only one country (except as otherwise discussed under Section 3, *Other Taxing Provisions That Determine Where the Trust Income Will be Taxed*); thirdly, that the situs of the trust assets is the same as the jurisdiction of its residency; and, finally, that, unless otherwise stated, that the comments are made in reference to personal *inter vivos* trusts.

2. Determining the Tax Residency of a Trust

The first issue with which a practitioner is presented is in which jurisdiction the trust will be resident for tax purposes. Although the tax residency of a trust may appear to be self-evident, it is imperative to understand how this determination is actually made, as the tax residency of the trust is the starting point for understanding how (and where) the trust and its beneficiaries will be taxed. Not surprisingly, the method of determining the tax residence of a trust differs between Canada and the U.S.; in fact the terminology under the Code[1] does not make use of the word "residence" in this context.[2]

A trust resident in Canada will be taxed on its worldwide income, while a non-resident trust will be taxed only on dispositions of taxable Canadian property and on Canadian source income. Similarly, a trust having a situs in the U.S. (a domestic trust) will be taxed as a U.S. resident on its worldwide income,[3] while a trust having a situs outside the U.S. (a foreign trust) will be taxed as a non-resident on income effectively connected with a U.S. trade or business and on fixed determinable income.

Other key (non-domestic) factors that will impact taxation are the residence of the beneficiaries (which, combined with the residence of the trust, will be the focus of this paper) and the jurisdiction in which the trust assets are located.

1. United States Internal Revenue Code, 26 U.S.C.A. § 1 et seq. [1986], as amended, hereinafter referred to as the "Code".
2. Interestingly, the place of the formation of the trust is immaterial in both Canada and the U.S. (although this factor may have implications at the state level).
3. As well a domestic trust (and not a foreign trust) may be characterized as a U.S. person, which has other implications under the Code. See 26 U.S.C.A. §7701(a)(30) and 7701(a)(31).

(1) Determination of Tax Residency Under Canadian Law

In Canada, the established common law test for determining the tax residence of a trust is that a trust will be a resident of the jurisdiction where its trustees reside and operate.[4] Generally speaking, this position was adopted by the Canada Revenue Agency ("CRA"),[5] and until recently, could be relied upon by practitioners. Recent decisions ("*Garron*", "*St. Michael's Trust*")[6] suggest that the courts are re-thinking the way that the residency of a trust should be determined. In brief, the Tax Court in *Garron* applied a central management and control test[7] (with some modifications), in order to determine the residence of a trust for tax purposes.[8] The long term impact of these cases is unclear.[9]

(2) Determination of Tax Residency Under U.S. Law

Given the American inclination to codify as much tax law as possible, trust residency (the language of the Code refers to domestic or foreign situs) is not surprisingly determined by reference to an objective standard.[10]

While the nuances of the test are many, in simple terms, if a trust meets both the court test[11] (a court within the U.S. must be able to exercise primary supervision over trust administration) and the control test[12] (one or more U.S. persons must have the authority to control all substantial decisions of the trust) it is taxed as a domestic

4. *Thibodeau v. Canada* (1978), 3 E.T.R. 168, [1978] C.T.C. 539, 78 D.T.C. 6376 (F.C.T.D.).
5. Interpretation Bulletin IT-447 "Residence of a Trust or Estate" May 30, 1980.
6. *Garron Family Trust v. Canada* (2009), 50 E.T.R. (3d) 241, [2010] 2 C.T.C. 2346, 2009 TCC 450, affd 2010 FCA 309 *sub nom. St. Michael's Trust Corp, as Trustee of the Summersby Settlement v. Her Majesty the Queen* ("*St. Michael's Trust*").
7. A test which has historically been reserved for determination of corporate residency.
8. In *St. Michael's Trust*, the Federal Court of Appeal determined that the approach in *Garron* was substantially correct.
9. Although if at the planning stage, it would be best to have the central control and management of the trust located in the jurisdiction where the trustees are resident.
10. *Small Business Job Protection Act of 1996* (H.R. 3348).
11. Title 26 of the Code of Federal Regulations ("26 C.F.R.") 301-7701-7(a)(1)(i). Note as well that a safe harbour exists which treats the court test as being met if certain conditions are satisfied.
12. 26 C.F.R. 301.7701-7(a)(1)(ii). The control test is based both on the concept of control (*i.e.* no one can veto the decisions) and the concept of substantial (generally non-ministerial) decisions.

trust.[13] By default, any trust that does not satisfy this two part test is taxed as a foreign trust.[14]

Prior to the introduction of the objective test, the situs of a trust was determined in reference to the facts and circumstances and included a review of the residence of the trustee, the location of the trust assets, the country under whose laws the trust was created, the place of administration, and the residence of the grantor and beneficiaries. If a trust was considered to have sufficient foreign contacts it was deemed to be foreign.[15] The evolution of the American system of classification is interesting to note in light of the changes which are at least threatened by *Garron*.

(3) Dual Residency

It is not uncommon following this analysis to find that a trust is a tax resident of both Canada and the United States under each country's respective domestic laws.[16] Treaties patterned after the Organisation for Economic Co-operation and Development ("OECD") model, such as the Canada-U.S. Treaty, contain specific tie-breaking rules for dual residents. Although the Treaty does define a "person" to include a trust, a review of Article IV of the Treaty clearly indicates that none of the determinative criteria (permanent home, center of vital interests, habitual abode, and nationality) are of assistance in deciding the residence of a trust. Instead, recourse must be had to the competent authorities, who must settle the issue by mutual agreement.[17]

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13. 26 U.S.C.A. §7701(a)(30)(E).
14. 26 U.S.C.A. §7701(a)(31)(B).
15. H.R. Rep. No. 658, 94th Cong, 2d Sess 206 (1976), S. rep. No. 938, pt I, 94th Cong, 2d Sess 215 (1976).
16. Canada, Department of Finance, "Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital", art. IV(1) online: <http://www.fin.gc.ca/treaties-conventions/usa_-eng.asp>, signed at Washington, D.C., on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007, (hereinafter referred to as the "Treaty"), also requires that the income of the trust be taxable in both countries, either to the trust or in the hands of the beneficiaries.
17. *Ibid.*, art. IV(4). While the commentary to the Treaty suggests that recourse to competent authorities will not be available for s. 94 trusts, the 2010 Federal Budget proposed that the *Income Tax Conventions Interpretation Act*, R.S.C. 1985, c. I-4, be amended to provide that a trust deemed to be resident under s. 94 will be a resident of Canada for treaty purposes. A trust that is deemed resident under these rules will be entitled to claim a foreign tax credit for income taxes paid to the United States (with certain limits)

3. Other Taxing Provisions That Determine Where the Trust Income Will Be Taxed

Unfortunately, resolving the question of where the trust is "factually" resident does not completely resolve the more important question of where the trust income will be taxed. Both Canada and the United States have adopted anti-avoidance and anti-deferral regimes the application of which can have the effect of subjecting the income of the trust to current taxation in more than one jurisdiction. Firstly, the Canadian non-resident trust rules (under new s. 94) and the foreign investment entity rules (under s. 94.1) will be reviewed. Secondly, some comments will be made on the U.S. foreign grantor trust rules (Code section 679). The U.S. foreign non-grantor trust rules, which are also anti-deferral provisions, will be discussed in subsection (3) *Code Section 679 — The Grantor Trust Rules*, in the context of a trust distribution from a Canadian trust to a U.S. beneficiary. A general understanding of these rules is necessary in order to avoid a host of unintended consequences.

(1) Section 94 — the New Non-Resident Trust Rules

Assume for the moment that an analysis of the trust agreement (and of the surrounding facts and circumstances) has indicated that the trust is a tax non-resident of Canada and a tax resident of the United States. The next step is to consider whether the trust income will nevertheless be subject to Canadian tax under the new non-resident trust rules in s. 94.[18]

Unlike former s. 94, the new non-resident trust rules eliminate the presence of a Canadian "resident beneficiary" as a necessary condition for subjecting a non-resident trust to Canadian income tax. Instead, there are two separate and independent measures for determining whether a non-resident trust will be deemed to reside in Canada for certain purposes of the Act, one of which requires only the existence of a Canadian "resident contributor" and the other of which requires the existence of both a "resident beneficiary" and a "connected contributor".[19]

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where the trust is considered a resident of the U.S. for tax purposes under U.S. domestic laws.

18. These rules have gone through numerous proposals and amendments, beginning with the 1999 Federal Budget and ending with the 2010 Federal Budget. It is proposed that the new NRT rules, once drafted in final form, will have retroactive application to 2007.
19. See proposed subsecs. 94(1) and 94(3) of the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.), as amended (herein referred to as the "Act").

Without engaging in a lengthy review of the technical language and implications of new s. 94 (and the related proposals and amendments), on which much commentary has been written, there are a few practical points that should be understood.

As proposed, s. 94 will apply to non-resident trusts having no nexus to Canada other than the existence of a Canadian "resident contributor". A "resident contributor" is an entity which at the time of the contribution (to the trust in question) is a tax resident of Canada and is a contributor to the trust.[20] The definition excludes individuals who have not, at the time of contribution, been resident in Canada for one or more periods totalling more than 60 months.[21] Although the term "contributor" refers most simply to a Canadian settlor or transferor, the definition of "contribution" and the associated rules of application are quite involved and cover a number of direct and indirect transfers[22] which expand the scope of "contributor" beyond the obvious. In considering whether a trust has a "resident contributor", it is important to note that a trust may have a "resident contributor" at one point in time and not at another point in time.[23]

Section 94 will also apply to non-resident trusts having both a "resident beneficiary" and a "connected contributor". There are two primary features of this test that should be noted for the purposes of this paper.

Firstly, the term "resident beneficiary"[24] is defined to include both persons that are directly beneficially interested in the trust and persons that may receive trust income or capital indirectly through other entities. The term does not include a "successor beneficiary".[25] A "successor beneficiary" is an entity which is a beneficiary solely because of a right of that beneficiary to receive any of the trust's

20. There are certain exceptions for arm's length transfers, exempt trusts, and a number of specific exceptions introduced into the concept of "contribution".
21. There are a number of exclusions to this 60-month threshold, including one for individuals and entities that have never been non-resident and one for individuals under the age of five. The definition of contributor also excludes an individual who transferred property to an *inter vivos* trust before 1960 while a non-resident and to which no transfers were made subsequent to 1959.
22. Proposed subsec. 94(1) and proposed subsec. 94(2) of the Act. See also the decision in *St. Michael's Trust*.
23. The trust is tested at the "specified time" (either at the end of the taxation year of the trust if the trust exists at year-end or at the time immediately before the trust ceases to exist if it does not exist at year-end). The loss of a "resident contributor" gives rise to a number of tax implications.
24. Proposed subsec. 94(1) of the Act. See also subsec. 248(25) of the Act.
25. There is also an exclusion for specified charities.

income or capital on or after the death of a contributor to the trust or a person who is related to a contributor to the trust (or an individual who would have been related to a contributor if every individual who was alive before that time were alive at that time). The meaning of this is that until the death that triggers the beneficial right (and assuming that the trust does not have other "resident beneficiaries"), the trust will not have a "resident beneficiary" and the trust will not be a s. 94 trust. As soon as the death occurs, however, the trust will have a resident beneficiary and, if there is a "connected contributor", the trust will be a s. 94 trust.

Secondly, the exclusions to the concept of "connected contributor" are critical; without them, any non-resident trust with even one Canadian beneficiary would be subject to tax in Canada in accordance with the rules. In simple terms, these exclusions cover contributions made by new immigrants[26] and contributions which are made during an entity's "non-resident time". For a contribution to be made during a non-resident time, the contributor must have been a non-resident for a period beginning 60 months prior to the date of the contribution and ending 60 months subsequent to the contribution (the "excluded period").[27] Where the contribution occurs as the result of the death of an individual, the excluded period begins 18 months prior to the date of the contribution and ends on the earlier of 60 months after the contribution or the death of the individual.[28] It quickly becomes apparent that this concept of "non-resident time", and the fact finding exercise that necessarily accompanies it, is crucial in cross-border planning.

If proposed s. 94 applies (incorporating the modifications contained in the 2010 Federal Budget), the trust will be taxable on either: (1) income attributable to property acquired by the trust from any Canadian resident, or certain non-residents, or property substituted therefor; and, (2) Canadian source income calculated under normal rules, together referred to as "Resident Property". Income from the trust's other property, referred to as "Non-Resident Property" will not be taxable in Canada.[29]

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26. This first exclusion is for an entity which was resident in Canada for a period or periods not exceeding 60 months: see proposed subsec. 94(1).
27. Under the former s. 94, a trust ceased to be subject to Canadian tax when the "connected contributor" had ceased to be a tax resident of Canada more than 18 months before the end of the tax year: see subcl. 94(1)(b)(i)(A)(II) of the Act.
28. For a contribution made prior to June 23, 2000, the excluded period for a transfer made at death begins 18 months prior to the end of the taxation year during which the contribution was made.
29. Under the rules as proposed prior to the 2010 Federal Budget, the trust

The mechanism of making beneficial distributions of income will differ under these rules, which are subject to ordering. Distributions to Canadian resident beneficiaries will be made firstly from Resident Property and distributions to non-resident beneficiaries will be made firstly from Non-Resident Property. Distributions to non-residents from Non-Resident Property will not be subject to withholding tax while distributions to non-residents from Resident Property will be subject to withholding tax.

Pursuant to the 2010 Federal Budget, the resident contributor's liability for the trust's tax liability will be limited to the contributor's proportionate share of the income[30] (calculated based on the fair market value of the property contributed by that contributor as compared to the fair market value of the total amount of property contributed to the trust by all connected contributors).[31] The resident beneficiary will continue to be jointly and severally or solidarily liable for the trust's tax liability, without relief.

(2) Section 94.1 — The Foreign Investment Entity Rules

Even if a thorough review of the facts clearly indicates that the trust is a tax non-resident of Canada and further, that the trust is not subject to the non-resident trust rules, the trust income may nonetheless be subject to current taxation in Canada if the foreign investment entity ("FIE") rules were to apply. This anti-avoidance and anti-deferral regime is often compared to the U.S. passive foreign investment company ("PFIC") rules.[32] Like those rules, the FIE provisions are designed to target the accrual of passive investment income offshore.[33]

The FIE rules have gone through multiple rounds of legislative

would be deemed to be a resident of Canada for certain purposes of the Act and would be taxable in Canada on its worldwide income.

30. The trust may allocate a share of its foreign tax credit to a contributor.
31. The attribution of income to a contributor would apply only to taxation years ending after March 04, 2010.
32. 26 U.S.C.A. §1291 through 1297. The PFIC rules are designed to discourage U.S. persons from investing in foreign mutual funds where the income and gains are not subject to current taxation in the U.S.
33. Existing s. 94.1 of the Act was implemented as a general anti-avoidance rule that would apply:

> "where a taxpayer invests in a non-resident investment fund and where one of the main reasons for the investment is to reduce or defer the tax liability that would have applied . . . if such assets had been held directly by the taxpayer".

Canada, Department of Finance, 1984 Budget, Budget Papers, February 15, 1984.

proposals since the proposals were first introduced in the 1999 Federal Budget. Many critical papers have been written on the history, scope, and complexity of these proposals and a review is beyond the scope of this paper. The important point is that pursuant to the 2010 Federal Budget,[34] the Canadian government has decided to scrap those proposals and keep existing s. 94.1 (with some minor modifications).[35]

The FIE rules will apply when the following three conditions are met. The first condition is met when a taxpayer holds an interest in property that is a share of the capital stock of, an interest in, or a debt of, a non-resident entity (other than a controlled foreign affiliate of the taxpayer, in which case a different taxing regime applies) or an interest in or a right or option to acquire such a share, interest or debt.[36] In the context of a trust, an interest will exist in respect of a trust to which the rules in para. 94(1)(c) or (d) of the Act apply (meaning a non-resident trust meeting the tests under paras. 94(1)(a) and 94(1)(b)).

The second condition is met when the interest may reasonably be considered to derive its value, directly or indirectly, primarily from portfolio investments of that or any other non-resident entity in certain types of assets.[37] This condition seems designed to encompass investments which are passive investments having the sole purpose of deriving income (as opposed to participating in the management of an entity in which a direct investment is made).[38]

Finally, the third condition is met where it may reasonably be considered, having regard to all the circumstances, that one of the main reasons[39] for the taxpayer holding the interest was to derive a benefit from the portfolio investments in such a manner that the taxes on the income, profits, and gains from such assets are significantly less than the tax on the income, profits and gains from such assets is significantly less than the tax under Part I of the Act that would have been applicable in that taxation year if the income, profits, and gains had been earned directly by the taxpayer.[40]

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34. Canada, Department of Finance, 2010 Budget, Canada's Economic Action Plan, Year 2, March 04, 2010.
35. Existing 94.1 refers to offshore investment fund property ("OIFP").
36. Paragraph 94.1(1)(a) of the Act.
37. Paragraph 94.1(1)(b) of the Act.
38. B. Weiner, "Foreign Investment Entities: Unresolved Issue", CCH Tax Topics No. 1987, April 8, 2010, p. 3.
39. The question of whether the taxpayer had a tax avoidance motive was irrelevant in the FIE proposals. The re-introduction of this condition narrows the scope of these rules. See *Walton v. Canada*, [1999] 1 C.T.C. 2105, 98 D.T.C. 1780, 78 A.C.W.S. (3d) 1038 (T.C.C.).

From a planning perspective, this last condition is of great importance, as it should often be possible to show that no tax avoidance motive exists where a legitimate estate planning structure has been put in place (or where the entity in question is an estate). The test, however, is not as straightforward as it would first seem. The test has two parts: (1) did the taxpayer in fact obtain a significant tax benefit; and, (2) if so, is it reasonable to conclude, having regard to all the circumstances, that the taxpayer had as a main reason for investing the obtainment of that significant tax benefit.[41]

While the first part of the test is clearly comparative (the taxes that were actually paid by both the non-resident entity and the Canadian taxpayer are compared with the taxes that would have been paid under Part I), the second part of the test is more difficult to understand, since it would appear that this is an objective test under which the taxpayer will be automatically considered to have as a main reason for investing the acquisition of a tax benefit if the non-resident entity did not make distributions "at least equal to and of the same nature as the income earned on the portfolio investments it holds".[42] This could obviously be problematic where, as in the case with many personal trusts, income is not distributed currently.

It would appear, however, that the courts are willing to view the test as a subjective one, and will in fact consider the taxpayer's actual reasons for investing.[43] Factors that may be considered include: whether the taxpayer could have acquired the underlying investment assets directly, whether the taxpayer had a risk of loss, whether an entity in Canada could have provided a similar service as that found offshore, whether the taxpayer consciously chose lower returns in order to benefit from deferral or tax savings, whether the investment comprised a significant portion of the taxpayer's total portfolio, and whether the nature of the investment was consistent with the taxpayer's overall investment history, objectives and strategy.

While the application of these rules will not cause the trust itself to become subject to Canadian taxation, the rules do subject the beneficiary to a rather draconian taxation regime. If the FIE rules apply to a trust, the result is that the Canadian beneficiary taxpayer holding the interest in the FIE will have a current imputed income inclusion in that taxation year. The annual income inclusion will be calculated on a monthly basis as the product of the taxpayer's

40. Subsection 94.1(1) and paras. 94.1(1)(c), (d) and (e) of the Act.
41. Subsection 94.1(2) of the Act.
42. CRA Document No. 9805415. See also Weiner, *op. cit.*, footnote 38, pp. 4-5 for a fuller discussion.
43. Weiner, *op. cit.*, footnote 38, at p. 5.

"designated cost"[44] of the interest in the FIE multiplied by the prescribed interest rate.[45] An amount equal to this income inclusion is then added to the taxpayer's adjusted cost base.[46] The inclusion is subject to criticism on the basis that it is arbitrary and bears no relationship to the actual return in the FIE. From a practical perspective this means that the value of the FIE could decline, while the taxpayer continues to have a current income inclusion. This creates a potential problem because although the income inclusion is added to the adjusted cost base, if the investment decreases, the taxpayer's cold comfort at the time of disposition will be a capital loss (which he may not be able to use).

This return to the existing FIE rules eliminates a great deal of planning that might otherwise have had to be undertaken for Canadian beneficiaries of foreign estates and trusts holding passive investment portfolios. Instead, (where the income is not currently distributed) the focus should be on documenting the planning work undertaken in order to ensure that the taxpayer will fail the motive requirement in the event of an audit. Another challenge, should the FIE rules apply in respect of a particular trust, will be to collect sufficient information from the trustees to allow the beneficiaries to meet their filing obligations.

(3) Code Section 679 — The Grantor Trust Rules

The foreign grantor trust rules found in Code section 679 have often been compared to the many proposed variations of the new s. 94 non-resident trust rules;[47] certainly greater similarity between these two regimes was created as a result of the recent minor changes to s. 94 introduced in the 2010 Federal Budget. In any event, the ultimate effect of these systems is the same, namely, to subject the worldwide income of a foreign trust to domestic taxation. The grantor trust rules are relevant to this discussion as their application may result in the U.S. taxation of income earned by a Canadian trust.

44. Any interest acquired by a Canadian beneficiary will have an adjusted cost base for the purposes of para. 94.1(2)(a) equal to the fair market value at the date of acquisition. The designated cost of a "prescribed OIFP" is *nil* where it is acquired as a result of bequest or inheritance from an individual who had not been resident in Canada for a period of 60 months prior to the date of death (subject to some restrictions).
45. The prescribed rate is the three month average Treasury bill rate plus two percentage points, divided by 12.
46. Pursuant to para. 53(1)(m) of the Act.
47. A number of excellent commentaries have been written on this subject. See E. Roth, "Canadian Taxation of Non-Resident Trusts — A Critical Review of Section 94 of the Income Tax Act" (2004), 52 Can. Tax. J. 329.

The theory underlying the domestic grantor trust rules[48] is that an individual should continue to be taxed on the income generated by property transferred to a trust when the nature of the transfer or the nature of the rights and powers retained by the individual over the transferred property[49] are of a quality such that the individual should be treated as the owner of the property for tax purposes.[50] The effect of these rules is that the grantor will be required to include in his income (on his personal U.S. return) the worldwide income of the trust.[51]

The foreign grantor trust rules in s. 679, which apply when a U.S. person[52] has made a transfer to a foreign trust having at least one U.S. beneficiary, are slightly different in that they will apply even where the grantor[53] has relinquished all powers or interests in the trust. The classification of a foreign trust as a grantor trust is dependant both on whether the transfer was made by a U.S. person[54] and on whether any of the trust's beneficiaries are U.S. persons.[55] It is important to note that these rules do not apply either to transfers that occur "by reason of death of the transferor"[56] or to transfers that occur at value.[57]

The question of whether a trust has a U.S. transferor may seem straightforward;[58] however, it is important to monitor the immigration status of the transferor in order to ensure that events

48. 26 U.S.C.A. §671 to 677. For an excellent discussion of the U.S. foreign grantor trusts see W.H. Newton, *International Income Tax and Estate Planning*, 2nd ed. (St. Paul, MN: Thomson/West, 2004), at chapter 6.
49. In general the transferor must retain substantial "dominion or control" over the trust. The types of powers that will result in a U.S. domestic trust being a grantor trust are well-established.
50. For the purposes of this paper the reference to tax here refers to income taxation, not estate taxation. Inclusion of transferred property may also be subject to estate taxation (determined under a separate set of criteria).
51. 26 U.S.C.A. §679(a)(1). More precisely, the grantor will be treated as the owner of the portion of the trust attributable to the property that he transferred and will only be taxed on the income generated from that portion.
52. The requirement that a foreign trust have a U.S. transferor or settlor was introduced by the *Small Jobs Protection Act of 1996*, in order to prevent the income of trusts having U.S. beneficiaries and a foreign grantor to escape U.S. taxation completely.
53. In this paper this term is used interchangeably with the term transferor, to refer to an individual who has made a transfer to the trust.
54. 26 U.S.C.A. §7701(a)(30). The term "U.S. person" refers to a U.S. citizen or resident, a domestic U.S partnership, a domestic U.S. corporation, or a domestic U.S. estate or trust. The paper will not discuss the Code provisions addressing citizenship and residence of an individual.
55. 26 U.S.C.A. §679(a)(1).
56. 26 U.S.C.A. §679(a)(2)(A).
57. 26 U.S.C.A. §679(a)(2)(B).

such as the immigration of the transferor to the U.S. or their acquisition of U.S. citizenship within five years of the date of transfer[59] do not accidentally cause the trust to become subject to the grantor trust rules.[60] This unfortunately happens quite frequently.

If a change in the status of the transferor does occur, the transferor's obligation to include the appropriate portion of the trust's current income on his own personal U.S. return will begin as of his residency start date (or as of the date that citizenship is acquired). The accumulated income of the trust (more technically, the "undistributed net income" of the trust, a concept discussed below) will factor into the determination of what portion of the trust assets are appropriately attributable to the transferor. More disturbingly, if the transferor later gives up his status as a U.S. person, he will be considered to have made a transfer to a foreign trust at that time, and will be subject to taxation on any accrued but unrealized capital gains.[61]

In determining whether a trust has a U.S. beneficiary,[62] it should be noted that a foreign trust is automatically considered to have a U.S. beneficiary unless no part of the income or capital of the trust may be paid or accumulated for the benefit of a U.S. person and, in the event that the trust were to terminate in the taxation year in question, no part of the income or capital of the trust could be paid to or for the benefit of a U.S. person.[63] While the mere possibility that the trust might acquire a U.S. person beneficiary will not be sufficient to cause the trust to have a U.S. beneficiary for the purposes of Code section 679, the most conservative approach (and the only one likely able to withstand audit) would be to expressly prohibit the trust from having U.S. beneficiaries under the terms of the trust.[64]

The test is made annually. The emigration of a Canadian beneficiary[65] to the U.S. or his acquisition of U.S. citizenship

58. Note that the rules contemplate direct, indirect and constructive transfers (which may occur in the exercise of certain Canadian estate plans).
59. 26 U.S.C.A. §679(a)(4)(A).
60. Surprisingly, the rules may also inadvertently apply where a U.S. citizen and a Canadian (non-U.S.) spouse make a joint filing election in the U.S., causing the non-U.S. spouse to be treated as a U.S. person throughout the taxation year. See Newton, *op. cit*., footnote 48, chapter 6, 6:12.
61. 26 C.F.R. 1.679-5(b)(1) and 26 U.S.C.A. 684.
62. Attribution rules apply in determining whether a trust has a U.S. beneficiary. See 26 U.S.C.A. §679(c)(2).
63. 26 U.S.C.A. §679(c)(1) and 26 C.F.R. 1.679-2(a)(1).
64. Obviously this clause would have to be enforceable under the other terms of the trust and under applicable law (for example if a beneficiary whose rights were cut off upon becoming a U.S. citizen could successfully challenge the trustees, the prohibitive clause would be insufficient).

within 5 years of property being transferred to the trust by a U.S. person will result in the trust being characterized as a grantor trust.[66] If this occurs the grantor will include in his income for that year the current income of the trust[67] and will also be taxed on all accumulated income (applicable to the portion of the trust attributed to him) calculated as of December 31 of the preceding taxation year.[68] Where the trust document is already in existence but the planning is occurring prior to the year in which the beneficiary becomes a U.S. person, the trustees should consider distributing all of the trust's undistributed net income (to avoid its inclusion in the grantor's income).[69]

While practitioners are obviously limited in the extent that they can restrict the movements and actions of trust transferors and beneficiaries in order to secure tax advantages (or avoid tax disadvantages), it is important to undertake a thorough examination of the citizenship and residency status of the clients during the initial fact finding stage. As well, it is useful to evaluate at that time whether the family or the trust is likely to develop U.S. connections in the future and to monitor those plans going forward.

4. Tax Implications of a Distribution from a Canadian Trust to a U.S. Beneficiary

In general, a trust will make two types of distributions to its beneficiaries during the course of its existence: distributions of current income and distributions of capital (in partial or complete satisfaction of a beneficiary's interest).

(1) Tax Implications Under the *Income Tax Act*

In general, when a Canadian trust makes a distribution of income to a U.S. beneficiary,[70] it will receive a corresponding deduction.[71]

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65. For Canadian tax purposes the beneficiary's interest in the trust should not be subject to the deemed disposition rules. An interest in a personal trust is excluded property if it is not acquired for consideration. Subparagraph 128.1(4)(b)(iii) and para. 128.1(10)(j) of the Act.
66. 26 U.S.C.A. §679(c)(3). An individual will not be a U.S. person for the purposes of these rules if they become a U.S. person after the 5-year period has expired.
67. Based on the proportion of the property originally transferred by the grantor to the total assets of the trust.
68. 26 U.S.C.A. §679(b); 26 C.F.R. 1.679-2(c)(1). They will be subject as well to the interest charge under 678.
69. Newton, *op. cit.*, footnote 48.
70. While a trust will clearly have a U.S. beneficiary if a U.S. citizen or tax

That income distribution will be subject to a non-resident withholding tax under Part XIII of the Act.[72] The statutory rate of withholding is reduced under the Treaty to 15% for Canadian source income[73] and is completely eliminated for distributions of foreign (non-Canadian) source income.[74]

Distributions of income from an *inter vivos* trust[75] which are characterized as "designated income" will trigger the application of a Part XII.2 tax at a rate of 36%.[76] This tax is applied in addition to the withholding tax, and is assessed to the trust, not to the beneficiary.[77] The effect of this is to increase the overall rate of tax on designated income. The definition of "designated income" is quite expansive. For the purposes of this article, it is sufficient to be aware that it includes taxable capital gains from the disposition of taxable Canadian property,[78] income from a business carried on in Canada, and certain capital gains transferred to the trust in anticipation of the transferor becoming a non-resident.

Because the Part XII.2 tax is assessed to the trust and not to the U.S. beneficiary no relief is available under the Treaty. The Part XII.2 tax is deductible to the trust. Because of the higher overall effective tax rate on designated income (distributed to a non-resident) it may be better to have this income retained and taxed in the trust.[79]

The trustees may also make distributions in kind (capital distributions) to non-resident beneficiaries. Unlike distributions to resident beneficiaries, which may occur on a roll-over basis (meaning that the beneficiary will inherit the trust's historical basis in the distributed property), an in-kind distribution to a non-resident

resident is a trust beneficiary, it should be noted that special attribution rules apply in determining whether a foreign trust has a United States beneficiary. These rules attribute beneficial rights of foreign entities (foreign corporations, partnerships, trusts, and estates) to United States persons who hold interests in those entities.

71. Subsection 104(6) of the Act.
72. Paragraph 212(1)(c) of the Act. The withholding tax will apply on the distributed income of the trust (as such term is understood under the Act) and on capital dividends. Although distributions of capital dividends are tax free to resident beneficiaries, they are fully taxable to non-residents.
73. Treaty, *op. cit*., footnote 16, art. XXII(2).
74. *Ibid*., art. XXII(2).
75. This Part XII.2 tax does not apply to testamentary trusts.
76. Section 210 and subsec. 210.2(1) of the Act.
77. Meaning that the trustee has the obligation to report and remit the tax.
78. The scope of which was narrowed under the 2010 Federal Budget.
79. Part XII.2 tax does not apply in the case of distributions of designated income from estates; in the case of an estate, it might be advisable to distribute the income and have it taxed to the beneficiary in the form of a withholding tax.

beneficiary will be treated as a deemed disposition[80] at fair market value.[81] The trustees may elect to have the gain taxed at the trust level;[82] alternatively, if the election is not made, the gain will be taxed to the beneficiary.

The trustees may actually wish to have the gain taxed in the hands of the beneficiary and should consider not making the election where the Part XIII tax assessed in respect of the distribution will be lower than the Part I tax that would otherwise payable by the trust.[83] In this case the taxable portion of the capital gain (50%) would be subject to withholding,[84] while the non-taxable portion of the distribution would be characterized as a capital distribution and would not be subject to additional tax.[85] The amount of the taxable portion of the distribution would be deductible to the trust.[86]

Note as well that a capital distribution will be deemed to be a sale of the beneficiary's interest in the trust,[87] possibly requiring the trustees to file for a compliance certificate.[88]

(2) Tax Implications to the Beneficiary Under the Internal Revenue Code

The next step is to understand how the U.S. beneficiaries will be taxed in the United States. Apart from the multitude of non-tax considerations which often dictate how a trust will be administered,

80. Paragraph 107(2)(a) of the Act. The trustees may elect to defer payment of the tax realized as a result of the distribution (and must post sufficient security).
81. Subsection 107(5) and para. 107(2.1)(a) of the Act. The adjusted cost basis to the beneficiary will be the fair market value. See para. 107(2.1)(b) of the Act.
82. Subsection 107(2.11) of the Act. If the beneficiary later disposes of the property, the trust will receive a foreign tax credit in the amount of the foreign taxes paid on the portion of the gain that accrued prior to the distribution.
83. If the distributed property is designated property, it will be subject to the Part XII.2 tax and may be better off taxed within the trust.
84. Interpretation Bulletin IT-465R "Non-Resident Beneficiaries of Trusts", September 19, 1985, para. 17; CRA document no. 2003-0000695, June 24, 2003.
85. A Canadian trust will not receive a deduction upon making a distribution of trust capital. Accordingly, no withholding tax will apply to such distribution.
86. Subsection 104(6) of the Act.
87. Subsection 107(5) and para. 107(2.1)(a) of the Act.
88. Section 116 of the Act. If the trustees fail to file they will be liable for 25% of the proceeds of disposition. Note that under the 2010 Federal Budget a capital interest in a trust will no longer be taxable Canadian property by default; instead the rules will look through the trust to the underlying property.

the manner in which the beneficiaries are taxed outside of Canada should be a primary consideration in determining whether income should be distributed currently or retained in the trust to be distributed as capital at a future date. Generally speaking, when a non-resident beneficiary is involved the trustee should consider whether the Canadian withholding tax will be available as a foreign tax credit,[89] whether a capital distribution will be subject to tax in the foreign jurisdiction, and whether income will taxed at a higher rate inside the trust or in the hands of the beneficiary.

For U.S. purposes, the distinction between income and capital (as understood under the Act) is irrelevant in determining how a distribution will be taxed in the hands of a U.S. beneficiary (instead the determination is tied to the concept of "distributable net income", discussed below). Trustees of trusts having U.S. beneficiaries must be cognizant of this because the application of the U.S. rules can result in a U.S. beneficiary being taxed in their home jurisdiction on distributions of what would be considered tax paid and tax free capital for Canadian purposes.

(a) Trust Classification

In addition to classifying a trust as domestic or foreign, the Code further characterizes a trust as being either a grantor or non-grantor trust[90] and again as being either a simple or complex trust.[91] A discussion of these dense classification rules is beyond the scope of this paper, which will deal primarily with the foreign non-grantor trust rules that apply to trusts established by foreign persons for the benefit of U.S. beneficiaries. It is important to note that for U.S. purposes, where a foreign trust is characterized as a grantor trust, the U.S. tax liability will be imposed on the U.S. grantor, and not on the U.S. beneficiaries.

The purpose of the foreign non-grantor trust anti-deferral and anti-avoidance rules is to discourage the use of foreign trusts to erode the U.S. tax base by allowing for the accumulation of foreign source income in the trust. Basically, the rules will apply in situations where the U.S. grantor trust rules would not be effective in accomplishing

89. Where the basis for taxation differs there is a risk of double taxation if the tax item is taxed in the Canadian trust and again upon receipt by the beneficiary by the foreign jurisdiction.
90. 26 U.S.C.A. §671 through 679.
91. 26 U.S.C.A. §652(a) and 662(a). A simple trust is basically a trust in which all income must be distributed currently. All income of a foreign non-grantor simple trust is taxed in the hands of the beneficiary.

this goal. These rules apply to both *inter vivos* and testamentary trusts.[92]

(b) Distributable Net Income

The concept of "distributable net income" (and the associated rules and definitions) is crucial in fostering an understanding of the manner in which the U.S. beneficiaries of non-grantor foreign trusts[93] are taxable in the U.S. on trust distributions. It is often ignorance about this fundamental trust tax accounting system which plants the seed for appalling complications, most of which lead directly to deteriorating relationships between the trustee and their beneficiaries or between the beneficiaries themselves.

There are a number of points which are relevant to an understanding of why the concept of "distributable net income" (and "undistributed net income" or "UNI") is important:

Firstly, in order to prevent the accumulation of income in the foreign trust it must be possible to establish what amounts should in fact be characterized as current income. This is determined by calculating the "distributable net income" ("DNI") of the trust, which dictates whether income earned by the trust should be taxed to the trust, to the beneficiaries, or partly to each.

Secondly, because trust distributions are measured against DNI, the distinction between income and capital distributions becomes meaningless — all distributions to the extent of the DNI ceiling are treated as distributions of trust income.

Thirdly, DNI allows the trust to operate as a conduit by allowing income generated at the trust level to retain its character when it is passed through to the beneficiaries.[94]

DNI is not identical to gross income; in rough terms it is gross income with certain adjustments and inclusions.[95] Although DNI is a determinative factor with respect to both domestic and foreign trusts, the calculation of distributable net income differs as between foreign and domestic trusts with foreign trusts being disadvantaged. The effect is that a U.S. beneficiary of a foreign non-grantor trust will be taxed on income items that are excluded from DNI for domestic

92. 26 U.S.C.A. §7701(a)(31)(B); C.F.R. 301.7701-4(a).
93. Distributable net income also applies to U.S. domestic trusts and to the taxation of foreign beneficiaries of U.S. domestic trusts. It governs not only the amount taxable to the beneficiary but also measures income at the trust level (by limiting the distribution deduction to which the trust is entitled for beneficiary distributions).
94. 26 U.S.C.A. §652(b) and 662(b).
95. 26 U.S.C.A. §643(a)(3).

trusts such as foreign source income, capital gains, and income otherwise exempt by Treaty.[96]

The requirement that a foreign trust include all of its capital gains[97] in DNI is a major disadvantage. A U.S. domestic trust is required to include in DNI only distributed capital gains and capital gains that are allocated to income under the terms of the trust settlement.[98] The effect of this (which can be significant) is that a Canadian trust that allocates undistributed capital gains to corpus (and has the item taxed within the trust) has created a potential problem for the U.S. beneficiary, who will ultimately be subject to U.S. tax on that undistributed gain when a capital distribution is made.[99]

A U.S. beneficiary who receives a distribution[100] from a non-grantor foreign trust (other than a distribution of undistributed net income, which will be discussed below) will be subject to tax in the United States to the extent of trust DNI, which operates as a ceiling to limit the amount of income[101] on which he may be taxed.[102] Distributions of DNI, including distributions of capital gains[103] distributed in the year that they were realized by the trust, will retain their character in the hands of the beneficiary.

The beneficiary will also include in income the amount of any foreign taxes paid by the foreign trust in respect of non-U.S. source income, subject to the usual limitations.[104] The beneficiary may claim a foreign tax credit or may instead choose to deduct his proportionate share of the taxes paid. As well, the Canadian withholding tax will be available as a credit.

Capital gains that are not currently distributed will lose their character and, when distributed, will be taxed in the hands of the

96. 26 C.F.R. 1.643(a)-6(a)(3)(i).
97. This refers to realized capital gains. Losses are also required to be included.
98. *Supra*, footnote 95.
99. This is because transactions on account of capital for Canadian purposes must be included in DNI for U.S. purposes.
100. 26 U.S.C.A. §643(h). Distributions from a foreign trust that are paid to a U.S. person indirectly through a nominee are considered to be paid directly from the trust.
101. It is beyond the scope of this paper to address the role of "fiduciary accounting income", which also determines in part the amount of income taxable to the beneficiary, or to review how DNI is allocated as between different classes of beneficiaries.
102. A foreign non-grantor complex trust is considered a non-qualified complex trust for the purpose of these rules.
103. The beneficiary will include their proportionate net share of the trust capital gains in their own income for the purpose of determining their net capital gains and losses for that taxation year.
104. 26 U.S.C.A. §901(b)(5).

beneficiary as ordinary income. The still relatively significant difference in the long term capital gains rate and the rate of taxation on ordinary income means that the accumulation of capital gains in the trust can have a substantial impact (even before consideration of the punitive tax treatment relating to receipt of UNI).

(c) Undistributed Net Income and the Accumulation Distribution

Distributable net income is determined at the trust level and is also used in determining the taxation of the beneficiary. On receipt of a distribution, and with DNI as a ceiling, the beneficiary will first be taxed on what are referred to as "first tier distributions" (generally speaking this refers to amounts which are required to be distributed under the terms of the trust) and secondly on "second tier distributions" (generally speaking this refers to other amounts properly paid, credited, or required to be distributed.[105] Finally, if the amount distributed exceeds DNI, the beneficiary will have an excess distribution some part (or all) of which may be subject to punitive taxation.[106]

An accumulation distribution occurs when discretionary distributions to the beneficiary are greater than DNI less the amount required to be distributed for that taxation year.[107] If the trust has UNI, the accumulation distribution will be subject to what are commonly referred to as the "throwback rules". Accumulated income which is subject to the throwback rules does not retain its character in the hands of the beneficiary and is taxed as ordinary income.[108]

The trust's UNI for a taxation year is calculated as the amount by which the trust's DNI in that year exceeds the sum of: (a) the amounts distributed that year and (b) the taxes imposed on the trust.[109] The

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105. The purpose of this tier system is to allocate DNI between classes of beneficiaries having different interests if the amount distributed exceeds DNI.
106. Discretionary distributions which are in excess of DNI are treated either as non-taxable distributions of capital or as accumulation distributions. It should be noted that loans from a foreign trust to a beneficiary or to a person related to the beneficiary will be characterized as trust distributions for these purposes.
107. 26 U.S.C.A. §665(b).
108. 26 U.S.C.A. §667(a).
109. 26 U.S.C.A. §665(a) and 665(d). "Taxes" for this purpose include U.S. income taxes, foreign income taxes, war profit taxes, excess profit taxes and

excess distribution is applied to soak up the UNI from the current taxation year and then moves backward soaking up UNI in each preceding year until either the UNI or the excess distribution is exhausted. Only after the excess distribution absorbs all of the existing UNI will the remainder of the excess distribution be considered a non-taxable distribution of capital.[110]

The beneficiary is not taxed until such time as the distribution is paid, credited, or required to be distributed.[111] In the year of receipt the beneficiary's tax liability in respect of the distribution is calculated as: (a) the regular income tax liability for the taxable year at the normal rates; (b) a partial tax on the accumulation distribution[112] calculated under section 667(b) on Form 4970; and, (c) the 668 interest charge calculated under section 668 on Form 3520.[113] There are a number of provisions that provide some minimal relief. Firstly, the amount of the interest charge plus the partial tax cannot exceed the amount of the accumulation distribution,[114] although this may be of little comfort to the beneficiary. Secondly, the beneficiary is allowed to reduce the amount of the tax owing by the amount of the taxes previously paid by the trust; however, no reduction is allowed for taxes previously paid by the trust which were imposed by a foreign jurisdiction. Instead, the beneficiary may claim a foreign tax credit for the amount of foreign taxes deemed distributed or they may claim a deduction,[115] although recourse to the Treaty may be necessary where a long period of time has passed.

The purpose of the interest charge is obviously to eliminate any advantage that the beneficiary may have been afforded by having the income accumulate in the trust. Accordingly, the amount of the interest charge relates to the deferral period and is applied directly to the partial tax.[116] The rate is equal to the compound rate which is generally applicable to underpayments of tax.[117]

An important point to make here is that all trust distributions received by a U.S. beneficiary are deemed to be accumulation distributions,[118] with the onus being on the beneficiary to prove

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taxes that would have been imposed on the foreign grantor if that person had been treated as the owner of the trust absent §672(f).

110. 26 C.F.R. 1.665(b)-1A.

111. *Supra*, footnote 108.

112. 26 U.S.C.A. §667(b). The mechanics of this calculation are beyond the scope of this paper.

113. *Supra*, footnote 108.

114. 26 U.S.C.A. §668(b).

115. 26 U.S.C.A. §667(d).

116. 26 U.S.C.A. §668(a).

117. 26 U.S.C.A. §668(a)(1) and 668(a)(6).

otherwise. Further, if no information is made available to the beneficiary, he must use the default method of calculation.[119]

If a beneficiary becomes a U.S. beneficiary at any time, the accumulation distribution calculation and the throwback rules will apply to him and, if excess distributions are made, they could trigger UNI inclusion in respect of UNI accumulated in the years prior to the beneficiary becoming a U.S. person.[120]

The paper has put a focus on this topic because it is an area which results in constant problems, both for Canadian trustees and for the U.S. beneficiaries who are subjected to unnecessary and heavy tax burdens. A Canadian trustee can avoid having the U.S. beneficiary become subject to this punitive regime by making current distributions of income or by exploring alternate cooperative planning structures with the beneficiary's U.S. attorney. If these options are not possible for whatever reason, the trustees should ensure that they are record keeping in such a way that they can provide the beneficiary with the information necessary to enable them to properly report and file their U.S. taxes and should also alert the beneficiary that they may wish to seek U.S. tax advice.

(3) Reporting

Although some of the reporting requirements have been addressed above, there are a number of other requirements worth noting:

1. Because the trust has U.S. (non-resident) beneficiaries, the trustees should prepare a Form NR4 Information Return in respect of any distributions and provide the U.S. beneficiaries with Form NR4 slips in respect of any distribution which is made. The withholding tax is required to be remitted by the trustee (withholding agent) and is remitted using Form NR-76 Non-Resident Tax Statement of Account. If the trustees do not properly remit Part XIII withholding they will be subject to penalties under the Act.
2. In the U.S., the beneficiary must report taxable distributions on his U.S. income tax return[121] and must file as well Form

118. 26 U.S.C.A. §604(c)(2)(A).
119. 26 U.S.C.A. §666(d).
120. See 26 U.S.C.A. §663(b). This allows for an election to treat all distributions made in the first 65 days of the taxation year as made on the last day of the preceding taxation year, with the result that the distribution will be (depending on the timing of the change of residency or acquisition of citizenship) treated as made before the change in status.
121. Form 1040: "U.S. Individual Income Tax Return", completing Part III, Schedule B.

3520,[122] which is required to be filed by any U.S. person who receives, either directly or indirectly, any distribution from a foreign trust in a taxable year.[123]

3. If the trust has a bank or investment account, the beneficiary must also file Form TD F 90-22.1 if his interest in the trust capital is in excess of 50% or if he receives in excess of 50% of the income from the trust.[124]
4. If the trust is considered a grantor trust under section 679, the grantor will be required to comply with various filing and reporting obligations (and must ensure that the trustee cooperates in providing IRS with the proper forms and information).[125]
5. As noted above, if adequate records are not provided, such that the IRS cannot determine the proper treatment of the income, the distribution will be treated as an accumulation distribution. This may be avoided by having the trustee provide the beneficiary with a Foreign Grantor (or Non-Grantor) Beneficiary Statement.[126] This statement should include: The name, address and U.S. taxpayer ID number of the trust; the name address and taxpayer number (if any) of the trustee; method of accounting used by the trust; taxable year of the trust; a statement indicating whether any grantor of the trust was a foreign corporation or partnership; the name, address, and taxpayer ID of the beneficiary, a description of the property distributed or deemed distributed to the U.S. person in the taxable year; information sufficient for the beneficiary to determine the U.S. tax treatment of any distribution;[127] information sufficient for the beneficiary to complete Forms 4970,[128] 5471, and 8261; a statement that the trust will permit either the Service or the U.S. beneficiary to inspect and copy the trust's records as necessary to

122. Form 3520: "Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts". See 26 U.S.C.A. §6048(c)(1).
123. 26 U.S.C.A. §6048(c)(1). This form is required to be filed even where no income tax is owing, and the requirement applies as well to distributions from foreign estates.
124. Form TD F 90-22.1: "Report of Foreign Bank and Financial Accounts". As has been recently and frequently publicized, a failure to file this form can lead to substantial civil (and in some cases) criminal penalties.
125. 26 U.S.C.A. §6048(a), (b)(1). In some situations a U.S. agent is appointed to ensure that the filing obligations are met.
126. Notice 97-34 (June 23, 1997) 1997-25 I.R.B.
127. Information similar to that found on Schedule K1 of Form 1041: "Beneficiary's Share of Income, Deductions and Credits".
128. Form 4970: "Tax on Accumulation Distribution of Trusts".

determine the nature of the distribution; and the name, address, and taxpayer ID of the trust's U.S. agent.[129] If the beneficiary cannot provide the Beneficiary Statement, then he may be able to avoid having to treat some portion of the distribution as an accumulation distribution by filing Form 3520 with information quantifying actual distributions for the last three years.[130]

(4) Other Issues for Consideration

The above provides a thorough review of the key issues that must be considered when dealing with a non-resident beneficiary of a Canadian trust. There are a number of other potential hazards to watch out for:

1. The beneficiary's interest in the trust may be subject to U.S. estate and gift tax (depending on whether the beneficiary possesses sufficient rights and powers over the trust assets, for example, a general power of appointment over his interest in the trust).
2. If the trust holds shares of a Canadian company that earns passive income the Code's anti-deferral regimes may apply to attribute the corporation's current year's income to the U.S. beneficiary or impose a penalty on deferred distributions.[131] If these rules apply the beneficiary will be subject to onerous reporting requirements in the U.S. and/or current income inclusion (and potential interest and penalties).[132]

129. Although a foreign trust with a U.S. beneficiary or grantor is not required to have a U.S. agent, if a foreign trust does not have a U.S. agent, the IRS may determine the amounts that are required to be taken into account by the U.S. owner for U.S. tax purposes: see 26 U.S.C.A. §6048(b)(2). A U.S. agent must be appointed to avoid this result.
130. The distribution in the tax year in question will be considered a distribution of current income based on the average of the current income distributed over the past three years.
131. See 26 U.S.C.A. §951 to 965 for the provisions governing controlled foreign corporations. See also 26 U.S.C.A. §1291 and §1293 to 1298 for the provisions dealing with passive foreign investment companies.
132. The primary anti-deferral regimes which might apply in this context are the Controlled Foreign Corporation ("CFC") rules and the Passive Foreign Investment Company ("PFIC") rules. The existence of a CFC in respect of a particular U.S. person requires that they file Form 5471: "Information Return of U.S. Persons With Respect To Certain Foreign Corporations", along with the applicable schedules. The existence of a PFIC requires the filing of Form 8621: "Return by a Shareholder of a Passive Foreign

5. Tax Implications of a Distribution from a U.S. Trust to a Canadian Beneficiary

(1) Tax Implications to the Beneficiary

This section of the paper will briefly review the tax considerations related to the reverse situation — trust distributions from a U.S. trust (which is not a s. 94 trust) to a beneficiary resident in Canada.

(a) Tax Implications Under the Internal Revenue Code

A Canadian beneficiary of a U.S. trust will be subject to tax on distributions of current income from a U.S. trust, limited by DNI. Income which is accumulated (and not currently distributed) is initially taxed to the trust.[133] To prevent double taxation, the beneficiary's tax on distribution will be reduced by the amount of the tax paid by the trust (with certain limitations).[134]

The extent of taxation is calculated in reference to the character of the distributed income, which is determined at the trust level[135] but which retains its character in the hands of the beneficiary.[136] As a result, the taxation of the beneficiary depends of the type of income received, as determined under the general Code provisions which govern taxation of non-residents. One notable difference, however, is that the beneficiary will be taxed on fixed and determinable income on a net rather than gross basis (since the deductions, normally disallowed for non-residents, will be taken at the trust level).[137]

Generally, this means that the beneficiary will be subject to tax on U.S. source fixed determinable income and effectively connected income and will not be subject to tax on foreign source fixed determinable income or effectively connected income.[138] Fixed determinable income is taxed at a flat rate of 30%,[139] reduced

Investment Company or a Qualifying Electing Fund". The CFC and PFIC regulations are dense and highly technical.

133. Distributions from a U.S. domestic trust to a Canadian beneficiary are *not* subject to the accumulation distribution and throwback rules (because the domestic trust is a "qualified trust").

134. *Supra*, footnote 112.

135. 26 U.S.C.A. §662(b), 667(e).

136. Note that both currently distributed income and accumulated income retain their character when distributed to a foreign beneficiary.

137. 26 U.S.C.A. §652(a), 662(a), 643(a).

138. Generally 26 U.S.C.A. §861(a)(1) and 861(b)(1). A non-resident beneficiary of a trust or estate engaged in a U.S. trade or business will also be deemed to be engaged in a U.S. trade or business: see 26 U.S.C.A. §875(2).

139. 26 U.S.C.A. §871(a)(1)(A).

under the Treaty depending on the type of income.[140] Effectively connected income is taxed according to the same principles (and at the same rates) as if it were received by a U.S. person.[141]

While effectively connected income (with the exception of gain from the disposition of a USRPI, discussed below) will not be subject to withholding if the proper forms are provided to the trustee,[142] fixed determinable income received by the beneficiary will be subject to withholding. Although the trustee acts as withholding agent, the tax is assessed to the beneficiary (and not to the trust).[143]

A withholding tax is also assessed on the disposition of a United States Real Property Interest ("USRPI"),[144] on the taxable distribution of a USRPI to the Canadian beneficiary, and on the disposition of an interest in a trust by the Canadian beneficiary.[145] To the extent that the gain in respect of the disposition is allocated to the Canadian beneficiary, the trustee is required to withhold 35% of the amount of such gain. In respect of the distribution or disposition of an interest in a trust, the trustee must withhold an amount equal to 10% of the fair market value of the USRPI.[146]

U.S. trusts may also make distributions in kind. Distributions of property pick up a share of DNI. The amount of the distribution for tax accounting purposes is limited to the trust's basis in the property immediately prior to distribution.[147] The beneficiary will include in income (subject of course to DNI) a value equal to the basis of the property and will receive a carry-over basis in the property.[148] This can roughly be equated to the rollout of capital property under the

140. The beneficiary would provide the trustee (withholding agent) with Form W-8BEN: "Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding".
141. The beneficiary would provide the trustee (withholding agent) with Form W-8ECI: "Certificate of Foreign Person's Claim That Income is Effectively Connected With the Conduct of a Trade or Business in the United States".
142. But will instead be reported on a non-resident return, Form 1040NR: "U.S. Non-Resident Alien Income Tax Return".
143. 26 C.F.R. 1.1441-5(b)(1).
144. 26 U.S.C.A. §897(c)(6) and generally 1445(e). See also 26 C.F.R. 1.445-5. Gains from the dispositions of U.S. real property and U.S. real property interests are treated as effectively connected income and are generally subject to withholding.
145. 26 U.S.C.A. §1445(e)(1)(4). This is similar to the new look-through rules relating to taxable Canadian property.
146. 26 U.S.C.A. §1445(e)(4) and 1445(e)(5).
147. 26 U.S.C.A. §643(e)(1) and 662(e)(2). The basis serves as a limit to the amount that the trust can deduct in respect of the distribution.
148. 26 U.S.C.A. §643(e)(3): alternatively, the trustee can elect under 643(e)(4) to have the trust realize the gain or loss, in which case the rules apply somewhat differently, with the fair market value serving as the upper limit on which the

Act, with the additional requirement that DNI must be taken into consideration and may require a current income inclusion.[149]

It is possible that the Canadian beneficiary's interest in the trust may be exposed to U.S. estate tax if he holds rights or prohibited powers which result in inclusion under the Code. Although a non-citizen, non-domiciliary is subject to tax only on U.S situs assets, the best view is that the situs of an equitable interest in a trust is determined by reference to the situs of the trust assets.[150]

(b) Tax Implications Under the *Income Tax Act*

The distribution of trust income to a Canadian beneficiary of a U.S. trust will be taxable in Canada.[151] The question of what constitutes income for these purposes is not addressed under the Act, although it is generally considered to refer to income as determined under Canadian tax law. The implication of this is that, depending on the nature of the trust assets, the U.S. trustee should keep a separate set of records for the Canadian beneficiaries and should be able to conclusively show whether a distribution was on account of income or capital.[152] Whether this is likely to occur is questionable.

Although the distributed income retains its character for the purposes of determining the amount and nature of the U.S. tax, it will not retain its character for Canadian tax purposes. A foreign tax credit is generally available in respect of the associated withholding tax but is not available in respect of foreign taxes paid by the trust.

Distributions of property from a non-resident trust are generally deemed received by the beneficiary at cost, unless subsec. 107(2.1) applies, in which case the property will be deemed received by the beneficiary at the greater of the cost to the trust and the fair market value of the property.[153]

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beneficiary is subject to taxation. The basis to the beneficiary would be the fair market value.

149. It should be noted that if the property qualifies as a specific bequest or gift, the property will not be subject to tax in the beneficiary's hands. Instead, the beneficiary's basis in the property will, in general, be the fair market value as of the date of the decendent's death. See 26 U.S.C.A. § 663(a)(1), 102(a) and 1014(b)(1). This issue often comes up in practice.
150. Rev. rul. 72-189, 1972-1 CB 442.
151. Subsection 104(13) of the Act.
152. For example, a distribution to an income beneficiary will clearly not be a capital distribution. Similarly, even distributions to capital beneficiaries should be meticulously recorded as being on account of capital and should be retained along with the proper trustee resolutions.
153. See generally subsecs. 107(1) to 107(5) and 107(2.1). The question of whether the property being distributed is taxable Canadian property or property that

Remember that to the extent that the NRT or FIE rules apply, the taxation of the trust income for Canadian purposes could change drastically.

(c) Reporting Requirements

There are some key reporting requirements to consider. Firstly, if the Canadian beneficiary is required to file a U.S. income tax return under 1.6012-3(b)(2)(ii), as a result of having effectively connected income, then the regulations require that the trustee file Form 1040NR and remit the tax on behalf of the beneficiary.[154]

The trustees must also file Forms 1042 and 1042-S, which are required to be filed in respect of withholding tax assessed on distributions of fixed determinable income to a non-resident beneficiary. Where a USRPI is disposed of or if an interest in a domestic trust is disposed of the trustee is obligated to file Forms 8288 and 8288-A.[155]

The Canadian beneficiary must report his income distribution on his personal tax return (Form T1). Both income and capital distributions are required to be reported on Form T1142: "Information Return in Respect of Distributions From and Indebtedness to a Non-Resident Trust".[156] Although Form T1142 does not require that information be provided at the time of filing, it is not unlikely that the beneficiary may be asked to provide additional information at a future date.

6. Conclusion

The purpose of this paper is to provide trustees and practitioners with an overview of the core tax issues which dictate where (and to

would not normally be subject to taxation in Canada is important in this context. A proper analysis of the relevant provisions should be undertaken to determine the tax treatment of the beneficiary both in respect of the property distributed and in respect of the tax implications to the beneficiary resulting from the disposition of his capital interest in the trust.

154. 26 C.F.R. 1.6012-3(b)(2)(i).

155. 26 U.S.C.A. §1445(e)(1)(5). Form 8288: "U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests"; Form 8288-A: "Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests".

156. Section 233.6 of the Act. The form should be filed with that individual's tax return for the taxation year in which the distribution was received. Note that subsec. 233.6(1) provides an exemption from filing Form T1142 for certain excluded trusts and where the trust is an estate that arose "on and as a consequence of the death of an individual" (recently addressed in CRA View document no. 2009-033252117).

whom) the worldwide income of a Canadian or U.S. trust will be taxed. The paper focused on these issues in the context of the residence (or citizenship) of the trust beneficiary and, to a lesser extent, the transferor. Throughout the paper it is stressed that a basic knowledge of the rules and how and when they might apply, the maintenance of relationships with the individuals that make the trust relationship possible (in order to maintain an understanding of how lifestyle might be impacting estate planning), and meticulous record keeping will go a long way toward avoiding some of the costly errors that can occur when these rules are ignored.