Tax Planning For Gifts And Bequests From Foreign Relatives

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Canada is a nation of immigrants. One interesting consequence is the large number of Canadian residents who have close family members living outside Canada. This can give rise to an interesting tax planning possibility.

Parents and other close relatives of Canadians often wish to include in their will bequests to their Canadian relatives. When they die, the bequest is sent to Canada, in cash or in kind, by the executor or administrator of the will. Sometimes, donors prefer to give a substantial gift to their Canadian relatives while still living, to see how the gift is enjoyed.

What are the Canadian tax consequences? There are no immediate consequences, as Canada does not tax incoming gifts or bequests. However, from the date the gift or bequest arrives in Canada, any income earned on it is taxable income of the recipient. A bequest of a small amount – or even of $100,000 – is not likely to earn sufficient income to be worth searching for ways to reduce Canadian tax on the income, but a large bequest means that a significant amount of Canadian tax on future income is likely, so a tax minimization plan is worth considering.

Plan First To Minimize Taxes

Unfortunately, once the gift has been made or the donor has died, it is too late to consider tax minimization; advance planning is essential. How can future tax be avoided? The answer is not simple, but with proper advance planning, it can be done.

A Canadian (let us call him or her "Lucky") needs to know that a substantial gift or bequest is planned. Without foreknowledge, nothing can be done.

Lucky must talk to the donor ("D") about a tax plan to avoid Canadian tax on future income earned by the gift or bequest. Lucky should ask D to settle an offshore trust in a jurisdiction that does not tax the income of the trust.

One important point – Lucky should confirm that D has no future plans to become a long-term Canadian resident.

The trust will be a "discretionary" trust, meaning that the trustee will run the trust at his discretion. The beneficiaries of the trust are known as "discretionary beneficiaries" because the trustee has absolute discretion to pay (or not to pay) capital or income of the trust to the beneficiaries. In this case, Lucky, spouse and children will be included in the trust deed as discretionary beneficiaries of the trust.

An offshore trust can be set up in many locations which do not tax the trust income. Examples are Bermuda, the Channel Islands of Jersey and Guernsey and several Caribbean islands including the Cayman Islands and the British Virgin Islands. New Zealand may be an appropriate location for the trust in some circumstances.

Once the location has been chosen, a local trustee (usually a trust corporation) has to be appointed by D. My preference is to use a trust corporation which has no connection with Canada – for example, an offshore subsidiary of a Canadian bank may not be appropriate. D will settle the trust (D is known as the "settlor") by making a nominal gift to the trust – perhaps $10 or a silver coin. If there is to be a future bequest or a current gift to D's Canadian relatives, it can be delivered to the trustee once the trust deed has been signed. If a bequest, D must immediately change his or her will, replacing Lucky by the offshore trust.

The trust deed (often prepared by the corporate trustee with guidance from Canadian and local lawyers) will give the selected trustee wide powers to invest or to distribute the capital and the income of the trust to the named beneficiaries. The trustee will be guided by a letter of wishes, prepared by D, which, in this example, will guide the trustee by suggesting that the trust corporation should hold the assets of the trust primarily for the benefit of Lucky and that, if Lucky makes a request for funds, the trustee should consider such request sympathetically. The letter of wishes is not a legal document, but is intended to help the trustee in making decisions.

The income earned by the offshore trust on the assets gifted to it by D will be accumulated in the trust free of tax and will be added to the capital of the trust annually, under local trust law.

Lucky may need to access part of the trust funds after the trust is up and running. In that case, Lucky will make a reasoned request to the trustee for a capital payment from the trust funds. Lucky will not have to pay Canadian tax on a capital distribution received from the trust. The trustee will almost certainly grant Lucky's request. Lucky will not ask for income, as that would be taxable in Canada.

The reason that this plan works is that neither the settlor, D, nor the trustee, have any connection to Canada, so Canada cannot tax the income of the trust. No Canadian taxpayer may make a contribution to the offshore trust under any circumstances, as that would make the trust taxable in Canada.

An additional wrinkle – which will help D ensure that the trust is run properly by the trustee – is to appoint a protector of the trust. The appointee will be referred to in the trust deed. This individual should not be a Canadian resident and will usually be a close friend or relative of D. The protector will often have the power to fire and replace the trustee and may also have other duties – for example, the trustee, having decided to make a distribution to the beneficiary, may be required by the trust deed to advise the protector, who must confirm the distribution before it is made.

Assets Are Also Protected

There is another advantage in settling an offshore trust. In the event of Lucky's marriage breaking down (?UnLucky?), the trust assets will not be part of his or her assets and so will not be claimable by his or her spouse. In certain family circumstances, this may be important to D. A recent UK Court of Appeal case suggests great care must be taken to be certain that the spouse cannot claim trust funds.

What is the downside? Cost! A Canadian trust/tax lawyer and a trust lawyer in the selected foreign jurisdiction will have to be involved in settling the trust, including preparing the trust deed. An experienced Canadian international tax adviser will be needed too, as co-ordinator.

The trustee will require an annual fee for acting as trustee and perhaps a set-up fee. These fees may be based on the value of the trust, the time spent managing it, or some combination of the two. There will normally be a minimum fee. "Fee shopping" may or may not be a good idea – sometimes you get what you pay for!

The costs involved (both one-time and recurring) must be compared with the future tax savings and any other benefits before making a decision to go ahead. That is why I mentioned earlier that the decision to go ahead with a plan like this will depend on the amount of the planned gift or bequest.

A practical problem, which I have come across frequently, is Lucky's reluctance to discuss with D matters related to D's death or the distribution of his or her assets.

I have made the above example as simple as possible. In practice, there will be many complicating variations – several beneficiaries, not just Lucky, the need for D to check with a tax adviser to ensure that setting up an offshore trust in his or her country of residence will not have adverse tax consequences, and many other points which must be considered by the professional advisers.

This is *not* under any circumstances a "do-it-yourself" project. Skilled help will be needed to ensure that all the possible complications are identified early and dealt with. However, the benefits, where large sums are involved, can be enormous – the tax saved each year and invested will itself earn income which is not taxable. The compounding effect over many years is a very important consideration.

As a final point, once a plan like this has been completed and the trust is operational, there are other uses to which the trust may be put. That will be the subject of another article.

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