Inheritances From Foreign Relatives – Tax Aspects

Arnold Sherman

Canada is a nation of immigrants. As a result, many Canadian taxpayers have family members resident in another country, and some can expect to receive an inheritance from overseas.

Inheritances are not taxable when received in Canada, but future income earned on the proceeds of the inheritance will be taxable in Canada at the recipient's top tax rate.

Can anything be done to eliminate this future tax? The answer is yes – with proper advance planning. Once the inheritance becomes payable, it is too late.

The solution is for the foreign relative (usually a parent) to set up an offshore trust in a jurisdiction which does not tax the trust income. If a Canadian taxpayer sets up or makes any contribution (cash or assets) to an offshore trust, that trust will be taxable in Canada. An offshore trust set up and funded by a non-resident of Canada (the "settlor" of the trust) will not be subject to Canadian tax.

The trust will have discretionary beneficiaries, including the (expected) Canadian beneficiary and perhaps other family members resident in Canada. The trustee of the trust (usually an offshore corporation specializing in offshore trust management) will make decisions about distributing trust assets to the specified beneficiaries. The trustee will be guided by a "letter of wishes" provided by the settlor. The trustee will normally follow this guidance, but is not legally required to do so.

The first step is a discussion with the individual planning the bequest. They must agree to change their will, replacing the planned Canadian beneficiary with the offshore trust. This can be the most difficult step!

If there is agreement about changing the will, you then need to talk to a Canadian tax practitioner with experience in the field about how to establish an offshore trust which will not be liable for Canadian tax. The tax adviser will suggest a suitable overseas jurisdiction for the trust, taking into account such factors as cost, time zone differences and the availability of skilled local help to set up and administer the trust. (If the trust appears to be in practice controlled from Canada, the Canada Revenue Agency will treat it as being resident in Canada and subject to Canadian tax — so having proper administration in the offshore jurisdiction is crucial.)

Other aspects of an offshore trust, such as the need for a protector, who will have special responsibilities such as the right to change the trustee, and for the trustee to be permitted to add beneficiaries later, must be discussed with the Canadian tax practitioner. These and other complexities are beyond the scope of this article.

The next step, a very important one, is a cost/benefit analysis. You should estimate the annual income and capital gains likely to be earned from the bequest. The estimated annual Canadian tax cost can then be compared with the one-time cost of setting up the offshore trust (including Canadian professional fees) and the annual cost of administering it, including the trustee fees. Unless the estimated future Canadian tax savings exceed the anticipated costs, it will generally not be advisable to go ahead. Absent special circumstances (discussed below), an inheritance of less than C$500,000 is unlikely to generate income sufficient to offset the costs of the offshore trust. Special circumstances, such as the example below,

or the possibility of a very large future foreign capital gain being realized in the offshore trust, could mean that an offshore structure should be considered, even for a much smaller inheritance.

There may be someone known to the Canadian, perhaps a relative or close friend, who is resident in a jurisdiction where it is appropriate to locate an offshore trust and who would be prepared to act as the trustee. If so, the costs may be reduced, so that this is worth considering with a smaller inheritance.

If a decision is made to go ahead, the foreign settlor must work with the Canadian professional advisor to set up the offshore trust – no doubt with significant input from the beneficiary. Funds to set up the offshore trust and to pay advisers must not come from a Canadian source. Just a symbolic amount may be contributed to the trust during the lifetime of the settlor, who will be responsible for the cost of maintaining the trust during his or her lifetime.

The next step is for the settlor to change his or her will as previously agreed. The planned Canadian beneficiary of the will should be replaced by the offshore trust.

Eventually, after the settlor passes away, the executor of the will forwards the bequest money to the offshore trust. The trustee will invest the proceeds at its discretion, taking into account the wishes of the settlor, perhaps as evidenced by a letter of wishes and probably with requested guidance from the principal beneficiary. All investment decisions must, however, be made by the trustee, and careful records have to be kept to show that the trustee outside Canada is genuinely making all decisions, not simply following instructions from Canada.

The trust will be incorporated in a jurisdiction that does not tax the trust income (typical examples include the Channel Islands (Jersey or Guernsey), the Cayman Islands and New Zealand). Each year after the first year, the trustee will make a formal written resolution to transfer the income of the previous year to the capital of the trust (known as capitalizing the income). A distribution to a beneficiary will be not from current trust income, but from capital (including capitalized income of earlier years). Such distributions are not taxable in Canada based on current law, but there are reporting requirements, with severe penalties for failure to report them.

I mentioned above one example of "special circumstances". Here is another. Suppose the Canadian beneficiary operates a business in Canada and wishes to expand overseas. Instead of investing personally in the new overseas venture, he or she could ask the trustee to consider making the investment from funds in the offshore trust. The beneficiary would have no direct connection with the new business, which would be supervised by the trustee, with professional management. The Canadian might be offered an assignment as a consultant by the new foreign venture, but must not be a director or an officer of the foreign company, nor must he or she appear to act as a director or officer. With careful structuring to minimize foreign withholding taxes on dividends paid by the foreign company to the trust, tax can be limited to minimal dividend withholding taxes, plus corporate taxation on the foreign profits. The possibility of such a future venture needs to be taken into account when the detailed terms of the offshore trust are being discussed.

Had the foreign investment been made by the Canadian individual, foreign profits would ultimately have been taxed as income of that individual, probably via a Canadian holding company. Set up as suggested above, foreign profits can be retained in the trust, capitalized, and then distributed as a non-taxable capital distribution to the Canadian beneficiary of the trust.

An offshore trust, based in a jurisdiction that permits it to have an indefinite life can be operated for the benefit of future generations, with proper advance planning.

In such circumstances, even a relatively small bequest may make setting up an offshore trust worthwhile.

This is a very complex subject and this article has only skimmed the surface of the available possibilities. Hopefully it will have piqued the reader's interest. In appropriate circumstances, it can lead to significant long-term savings of Canadian tax.

Arnold Sherman, CA (Canada), FCA (England & Wales), CPA (Cyprus), President, H. Arnold Sherman Professional Corporation, International Tax Consulting, Calgary, AB, (403) 269-8833, arnoldsherman@telus.net, www. arnoldsherman.com