MORRISON BROWN SOSNOVITCH LLP

BARRISTERS AND SOLICITORS

DEALING WITH NON-RESIDENT BENEFICIARES

"Globalization" of the Beneficiaries

I first started practicing law in 1980. My recollection is that was an era when it was unusual for there to be non-resident beneficiaries of an estate. Times have changed, and it seems that non-resident beneficiaries are more the rule than the exception.

Under the federal *Income Tax Act*, non-resident beneficiaries are treated fundamentally different than resident beneficiaries. Non-resident beneficiaries present estate trustees with a different set of challenges which carry the potential for personal liability to the Canada Revenue Agency if not dealt with correctly. As well, planning by estate trustees related to non-resident beneficiaries has significant potential to create issues between the resident and non-resident beneficiaries.

Distribution of Income to Non-Resident Beneficiaries

In the course of an estate's administration, the estate trustee will usually earn interest, probably some dividends, and perhaps other income such as rents or royalties. One-half of realized capital gains are also income for Canadian tax purposes. When income is distributed to Canadian residents, it retains its character and is taxed to the Canadian resident as if he or she had received it directly. The most obvious example is dividend income earned in the estate which when distributed to Canadian resident beneficiaries still retains its characterization a dividend with the full dividend tax credit for the resident beneficiaries.

This principle does not apply to non-resident beneficiaries and all of the income's original characteristics are lost. Withholding tax must then be deducted by the estate trustee from the remittance to the non-resident beneficiary and remitted to the Canada Revenue Agency of behalf of the non-resident. The rate of withholding tax starts at 25%, but may be reduced by international tax treaties – for example, the rate for individual non-residents who are in the United States now ranges between 10% and 15% depending on the nature of the income. The deduction and remittance of withholding tax requires the estate trustee to open an account with the CRA for this purpose, and involves some additional documentation to report to the CRA, and to the non-resident (to enable the non-resident to claim any foreign tax credits in his or her country of residence).

The estate trustee will be personally liable for failure to properly deduct and remit withholding tax from payments of income to non-residents.

Distribution of Capital to Non-Resident Beneficiaries

The CRA wants to be sure to collect its slice of tax from capital gains accrued on capital property distributed to non-resident beneficiaries. If the capital takes the form of cash, then it is fairly simple but if the distribution is of capital property – for example, shares, or an interest in real estate of the deceased, the issues around the distribution of capital are considerably more complex than those concerning the distribution of income.

Capital property can be distributed and transferred out of the estate to Canadian resident beneficiaries with a "roll-over", meaning the beneficiary receives it at the estate's cost base. When the Canadian resident sells it some time later, then it is the estate's historical cost which is used to compute the capital gain. The actual distribution and transfer however does not trigger any tax to the Canada resident.

This roll-over is not available to non-resident beneficiaries. To be certain that Canada receives its share of tax on any capital gain which has accrued at the time of distribution, the non-resident becomes immediately subject to Canadian tax on the gain. The enforcement mechanism is a requirement that the estate trustees must require the non-resident to obtain a Certificate (the "s. 116 Certificate") from the Canada Revenue Agency which is only obtainable if: (i) there is not tax payable (because there is not gain in the property, or the distribution is not subject to tax by Canada pursuant to the terms of one of its international tax treaties); or (ii) tax has been paid or the CRA is satisfied with security for payment provided by the non-resident.

Just as the estate trustee will be personally liable for failure to deduct and remit withholding tax, the estate trustee is also personally liable for a distribution of capital property to a non-resident beneficiary without having received the s. 116 Certificate.

Planning Distributions of Capital to Non-Resident Beneficiaries

There are some planning options available to avoid the tax consequences of distributing capital property to non-resident beneficiaries. Mainly, these options are:

(a) <u>Avoid the Distribution by continuing the hold the capital property in trust:</u> Since the tax on the non-resident only applies when there is an actual distribution, the estate trustee and the non-resident can agree that the trustee will continue to hold it in trust for the non-resident. This is especially useful if the intention is to hold the property for the long-term, and the non-resident beneficiaries intends to move (or return) to Canada at some future time. When Canadian residency is established or re-established, the property can then be distributed with the roll-over available to all resident beneficiaries. Additional planning is required with respect to income earned by the property which, if paid to the non-resident, will be subject to withholding tax.

(b) <u>Distribute the property to a Canadian corporation owned by the non-resident:</u> A corporation incorporated in Canada is deemed to be resident in Canada. Therefore, the

non-resident could incorporate a Canadian company and have the capital property distributed to it with the roll-over. The estate trustee will of course want appropriate directions and releases for doing so, and the non-resident beneficiary will have to plan around requirements for resident Canadian presence on the Board of Directors.

At first blush, this appears to be a simple answer to the non-resident's problem, but the holding of the property inside a Canadian corporation introduces a number of additional tax concerns, so professional advice specific to the situation is essential.

(c) Distribute property which has no accrued gains to the non-resident beneficiaries: If the estate has no, or quite small accrued gains in the capital property which it wishes to distribute, the tax consequences will be minimal and it is probably best to proceed with the distribution to the non-resident after obtaining a s. 116 Certificate. In other cases, the estate may have some property in which there are no accrued gains, and other property in which substantial accrued gains exist. In this situation, the estate trustee can consider distributing the capital property without gains to the non-resident, and the property with gains to the Canadian resident. If this alternative is being considered, it is imperative that the estate trustee obtain the agreement of all of the beneficiaries, because unless adjustments are made, the Canadian resident beneficiaries may be unhappy receiving property in which there are accrued gains which will be subject to tax at a future date and which therefore have a lower value on an after-tax basis.

March 2009

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