Dynasty Trusts
for Your U.S. Beneficiaries

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Dynasty trusts are generally established by wealthy Americans to protect and preserve their wealth for the benefit of future generations. While you may be a Canadian resident and not a U.S. person, if you will be leaving a significant inheritance to a child or other beneficiary who lives in the U.S. (or is considered a U.S. person for U.S. tax purposes), you may want to consider establishing a U.S. dynasty trust.[1]

A properly structured dynasty trust provides the following benefits for beneficiaries who are U.S. persons:

- **Minimizes U.S. transfer taxes –** A dynasty trust minimizes the impact of U.S. transfer taxes (such as U.S. gift or U.S. estate tax) that may be payable on the subsequent transfer of assets from a U.S. person beneficiary to the next generation (i.e., from your child to your grandchildren and great-grandchildren); who may also be U.S. persons.
- **Eliminates U.S. taxation issues impacting non-U.S. trusts –** A U.S. resident dynasty trust alleviates U.S. income tax issues associated with distributions made from a non-U.S. trust to a U.S. person beneficiary.
- **Avoids the "21-year deemed disposition rule" –** Extends the benefits of the dynasty trust over multiple generations as the "21-year deemed disposition rule" that applies to Canadian trusts does not apply to dynasty trusts set up in the U.S., provided the trust is not deemed resident of Canada. Under the "21-year rule," most Canadian trusts are deemed to have "sold" all their assets 21 years after the trust is created. The trust is required to pay capital gains tax on the deemed disposition – regardless of whether the assets are actually sold.

Minimizes U.S. transfer taxes

To appreciate the benefits provided by a dynasty trust, it is important to understand the potential financial impact of the three U.S. transfer taxes on U.S. persons.

U.S. Transfer Taxes

Gift Tax
U.S. persons are subject to gift tax on any property they gift during their lifetime. The gift tax is imposed on the giver (person making the gift) and not the recipient of the gift.

Estate Tax
U.S. persons are subject to estate tax on the fair market value of their worldwide estate assets at the time of their death.

If you leave assets directly to a U.S. person beneficiary and the individual transfers the assets during their lifetime or upon death, the gifted/ inherited assets could be subject to U.S. gift tax and estate tax; potentially reducing the amount of wealth that is transferred to the next generation.

Generation Skipping Transfer ("GST") Tax
In addition to gift or estate tax, the GST tax is imposed when there is a transfer of assets to a U.S. person who is more than one generation removed from the transferor. For example, a grandparent who gifts assets directly to a grandchild may be subject to the GST tax, in addition to the gift tax. The purpose of the GST tax is to ensure that gift and estate taxes are not circumvented by skipping one generation of beneficiaries; in this case the parent.

Who is considered a U.S. person?

The following individuals are considered U.S. persons and are subject to U.S. income tax and U.S. transfer taxes, which include gift, estate and Generation Skipping Transfer taxes:

- **U.S. citizens –** Individuals born in the U.S. or individuals born to U.S. citizen parents who have met certain U.S. presence requirements. Even if these individuals permanently relocate to another country, they continue to be considered U.S. citizens by the U.S. government.
- **U.S. residents –** For the purposes of this article, U.S. residents refer to individuals who are living in the U.S. and intend to remain living in the U.S. permanently and are considered to be domiciled in the U.S.
- **Green card holders –** Non-U.S. citizens who have been granted permission to live and work in the U.S.

The tax rates are the same for all three transfer taxes. The lifetime exclusion amount for gift and estate tax (combined) and for the GST tax is US$12.06 million per person for 2022, and is indexed annually for inflation. In addition to the lifetime exclusion amount, each U.S. person has an annual gift tax exclusion amount of US$16,000 per recipient. The current U.S. transfer tax rates are graduated rates between from 18 to 40 per cent, depending on the value of the property being transferred.

2022 U.S. Transfer Taxes

(Gift tax, estate tax and Generation Skipping Transfer tax).
All amounts are in US$

Lifetime Exclusion Amount: $12.06 million			
If the taxable amount is:			
Over (1)	But not over (2)	Tax on (1)	Tax rate on excess over (1)
$0	$10,000	$0	18%
$10,000	$20,000	$1,800	20%
$20,000	$40,000	$3,800	22%
$40,000	$60,000	$8,200	24%
$60,000	$80,000	$13,000	26%
$80,000	$100,000	$18,200	28%
$100,000	$150,000	$23,800	30%
$150,000	$250,000	$38,800	32%
$250,000	$500,000	$70,800	34%
$500,000	$750,000	$155,800	37%
$750,000	$1,000,000	$248,800	39%
$1,000,000		$345,800	40%

Source: Wolters Kluwer Limited, CCH

Lifetime exclusion amounts for gift and estate taxes

Any amount of the lifetime exclusion that is used towards one tax will have a corresponding decrease in the lifetime exclusion amount that can be applied towards the other tax. For example, if a U.S. citizen gifts US$2 million to their child, the gift must be reported to the Internal Revenue Service ("IRS") but there would be no tax payable on the gift (assuming the individual has not used their US$12.06 million exemption amount). However, after the gift, the lifetime exclusion amount for the U.S. citizen "giver" would be reduced to US$10.06 million (assuming the giver has already used their annual gift exclusion amount).

Assets transferred into a properly structured dynasty trust are protected and can be available for multiple generations without being eroded by U.S. transfer taxes that would otherwise be applicable to the U.S. beneficiaries.

Eliminates U.S. taxation issues associated with non-U.S. trusts

In some circumstances, when U.S. persons receive income that has accumulated in a non-U.S. trust, distributions that may have been characterized as capital gains – and therefore subject to preferential U.S. income tax treatment – may be treated as ordinary income and subject to standard U.S. income tax rates of up to 37 per cent. In addition, there would be interest charged to distributions from income accumulating within the trust in prior years. By establishing a dynasty trust, you avoid the U.S. income tax issues associated with being a U.S. beneficiary of a Canadian or other non-U.S. trust.

Avoids the "21-year Deemed Disposition Rule"

In order to avoid the U.S. tax issues previously discussed, as well as the 21-year deemed disposition rule that applies to Canadian trusts, most tax advisors recommend that the dynasty trust be set up as a U.S. resident trust while considering the "deemed resident of Canada" rules for trusts discussed later in the article. A dynasty trust extends benefits over multiple generations as the "21-year deemed disposition rule" that applies to Canadian trusts does not apply to dynasty trusts set up in the U.S. Under the "21-year rule," most Canadian trusts are deemed to have "sold" all their assets 21 years after the trust was created, at which point the trust is required to pay capital gains tax on the deemed disposition – regardless of whether the assets are actually sold.

Consider the residency of the trust

With a U.S. resident trust, one or more U.S. persons (including a U.S. corporation or trust) must have control over all substantial decisions related to the dynasty trust. Decisions that the U.S. person should have control over include, but are not limited to, the following:

- When distributions are made;
- The amount of distributions;
- When the trust should be terminated; and
- Investment decisions.

The state where you choose to set up the dynasty trust is also extremely important as the state determines how long the trust agreement can exist before a deemed disposition is required. For example, like Canada, some states limit the number of years before the trust must realize a deemed disposition, while others allow trusts to exist in perpetuity. The state in which the trust is established also determines whether ongoing state income taxes will be imposed on the trust. For example, a number of states do not subject the income accumulating in the trust to state income tax if there are no beneficiaries resident in the state. Therefore, consideration should also be given to the potential tax implications if the beneficiary decides to relocate to the state in which the trust is set up.

Other considerations when setting up a dynasty trust

Given the complexity of dynasty trusts, it is imperative to seek guidance from a tax professional with expertise in both Canadian and U.S. income tax and transfer tax legislation.

Following are several other considerations to discuss with your tax advisor when contemplating a dynasty trust:

- **Beneficiary access to trust funds**

  While the beneficiary child can be a trustee, they should only be able to participate in decisions to access the funds for limited purposes, such as health, education, maintenance or support needs (referred to as being limited by an "ascertainable standard"). If given broad powers to access the trust funds, the trust assets will be included in the beneficiary's estate upon their death. Therefore, for practical purposes it may be necessary to have additional trustees.

- **Deemed resident of Canada**

  Under Canadian tax law, a non-resident trust can be deemed to be resident in Canada for tax purposes in certain circumstances. In particular, these rules can apply if there are beneficiaries who reside in Canada or if there is a "Canadian resident contributor," (i.e., an individual or entity that is resident in Canada and a contributor to the trust). If you are a Canadian resident, the dynasty trust should be set up so that it is funded through your Will. Once deceased, and your estate is wound up, the Canadian tax authorities will likely no longer consider you a Canadian resident contributor. As a result, funding the trust through a Will can avoid the trust being deemed to be a Canadian resident trust if there are no beneficiaries of the trust who are Canadian residents.

- **Taxation of income earned in the U.S. resident trust for Federal income tax purposes**

  As mentioned previously in this article, the income earned in a trust may be subject to state income tax depending on the jurisdiction that is chosen for the trust's residency. In addition to any state income taxes, the income earned in the U.S. resident trust would be subject to U.S. Federal income taxes at the graduated rates that are applicable for trusts. It is important to consider that the highest U.S. Federal income tax rate applicable to income earned in a trust is triggered at a lower threshold of taxable income in comparison to income that is taxable to an individual. For example, according to the 2022 U.S. Federal tax rate tables, a single U.S. person would be subject to the highest individual tax rate of 37 per cent if they have taxable income that exceeds US$539,900; whereas a U.S. resident trust would be subject to the same rate if the taxable income exceeds US$13,450.

Example of a Dynasty Trust

	Dynasty Trust*			No Dynasty Trust*		
Generation	**Inheritance**	**Estate Tax**	**Net**	**Inheritance**	**Estate Tax**	**Net**
Child (U.S. person)	$10MM	NIL	$10MM	$10MM	$4MM	$6MM
Grandchild (U.S. person)	$10MM	NIL	$10MM	$6MM	$2.4MM	$3.6MM

*Asset growth, state and local estate taxes payable have not been included. All figures used to calculate U.S. estate tax are shown in U.S. dollars.

Example of a dynasty trust

The example above compares an adult child who resides in the U.S. and inherits US$10 million outright from a Canadian parent versus being the beneficiary of a US$10 million dynasty trust set up by a Canadian parent. The example assumes the Canadian parent has assets that are not subject to U.S. estate tax and the adult child has fully utilized their lifetime U.S. estate tax exclusion amount on other assets, and that their estate is taxed at 40 per cent.

A dynasty trust may also provide protection against creditors. Therefore, it may be worthwhile to consider a dynasty trust even if there are limited assets held within the trust. The professional fees associated with setting up this type of trust would likely exceed US$10,000.

How BMO can help

After working to accumulate significant wealth, you do not want to see the value eroded for future generations who reside in the U.S. due to U.S. transfer taxes. The dynasty trust provides a planning opportunity to protect your assets so that a larger portion of your estate will pass to future generations of your family who live in the U.S.

If you are considering a dynasty trust, your BMO financial professional can introduce you to qualified cross-border tax accountants and lawyers who can help you determine if this strategy is right for your family.

For more information, please speak with your BMO financial professional.

BMO Private Wealth

[1] Please note, this article is intended for Canadian residents only (i.e., not U.S. persons) who are considering setting up a dynasty trust for the benefit of U.S. person beneficiaries.

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