NetWorth

Post US Election – US Income and Estate Taxation

Many Canadians followed the recent US presidential election and may be wondering whether the US election results will impact their personal tax situation. If you happen to be a US citizen living in Canada or if you have significant US assets, the answer to this question is "maybe."

US Income Tax

If you're a US citizen living in Canada, you should be filing both Canadian and US individual income tax returns on an annual basis. The foreign tax credit mechanism generally results in a US citizen who is resident in Canada being subject to the higher tax rate between Canada and the US. For many US citizens, this means they are paying the Canadian individual income tax rate. However, since the net investment income tax (NIIT) which is essentially a US Medicare surtax, is not reduced by a foreign tax credit, some US citizens living in Canada may be subject to the 3.8% net investment income tax (NIIT). If you're impacted by the NIIT, president-elect Trump's proposal to eliminate the NITT may be good news as your overall tax burden could be reduced should the NITT be eliminated.

Other US individual income tax changes proposed by the president-elect include reducing the highest US individual income tax rate from 39.6% to 33% and eliminating the Alternative Minimum Tax (AMT).

US Estate Tax

Currently, a Canadian resident who owns US assets with a Fair Market Value over US$60,000 and who also has worldwide assets over US$5.49 million (2017 threshold) may be subject to US estate tax at the time of their death. One of president-elect Trump's proposals will eliminate US estate tax and replace it with a capital gains tax on appreciated assets held at death (with a possible exemption amount of US$10 million per couple). Given these proposals, Canadians who own a US vacation home, or those holding a significant amount of US assets personally, may find themselves in a situation where their potential US estate tax liability has been eliminated should these proposals eventually become law.

Given the uncertainty surrounding the current US tax environment, Canadians who may be impacted by US tax legislation should consider incorporating some flexibility in their tax and financial planning strategy.

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The Importance of Keeping an Estate Plan Current

An estate plan should take into account several matters, including personal relationships, financial resources and abilities of the individual and other family members, short-term and long-term goals and intentions, and various laws on a federal, provincial and international level. An estate plan should be reviewed on a regular basis, particularly where there has been a significant change in any of the foregoing. In addition, the following circumstances may elicit a change in existing estate planning documentation, such as Wills and Powers of Attorney ("Mandate" in Quebec):

- Death or disability of the executor ("liquidator" in Quebec) or attorney/mandatary
- Death or disability of a beneficiary
- Change in residency
- Births of new family members
- Marriage or divorce
- Significant change in assets

In recent years, there have been several significant changes in the law which may affect a pre-existing estate plan or the administration of an estate. Below is a summary of some of the noteworthy changes that have taken place in recent years:

British Columbia – The *Wills, Estates and Succession Act* came into force in 2014. Among the many changes imposed by the new legislation, the distribution scheme for intestate estates (where a person dies without a Will) has been amended, persons are now able to make a Will upon attaining the age of 16, and a marriage occurring after the date of the Will no longer revokes a Will.

Alberta – The *Wills and Succession Act* came into force in 2012, replacing several pre-existing pieces of legislation. Among the many changes imposed by the new legislation, marriage no longer revokes a Will (unless there is a contrary intention expressed in the Will), the effect of divorce on a Will has drastically changed, and two new classes of dependents who may make a claim against an estate have been added.

Ontario – Changes to the *Estate Administration Tax Act, 1998* became effective January 1, 2015 and impose additional reporting requirements on executors. Within 90 days of receiving a Certificate of Appointment of Estate Trustee (aka "probate"), the executor must complete and file an Estate Information Return which provides details as to the values of the individual assets comprising the estate. The executor must have appropriate appraisals or other evidence to substantiate the amounts, as the government has new auditing rights and may impose fines or imprisonment on executors who do not comply with the requirements.

Quebec – Trustees have a duty to act prudently and diligently. In some Wills, a clause is included to exonerate the liquidator or

trustee for all decisions made, unless such decisions are clearly fraudulent. In the 2015 case of *Bell v. Molson*, the Quebec Court of Appeal confirmed that because the duty to act prudently and diligently is of public order, it cannot be removed or restricted by an exoneration clause. Accordingly, as the court found that the trustees did not act prudently and diligently in that case, they were not permitted to rely on an exoneration clause to escape liability.

International – The European Union adopted a succession regulation which came into force in 2015. This regulation may affect Canadians if they have assets in one or more EU member states or habitually reside in one or more EU member states. The new regulation permits a person to designate in his or her Will which law is to govern certain succession matters. For example, certain European countries impose "forced heirship" rules which determine who is to receive certain assets of a deceased person. The new regulation may allow a Canadian resident to essentially opt out of the forced heirship rules by including a clause in his or her Will designating the laws of his or her province to govern succession.

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Federal – Commencing January 1, 2016, with limited exceptions, income retained in a testamentary trust (a trust arising as a result of someone's death, usually established in a Will) is taxed at the highest marginal rate. Prior to 2016, income retained in such trusts was taxed at graduated rates. As a result of these changes, some existing estate plans may need to be reviewed and revised. For example, the new rules may affect certain income splitting arrangements and disability planning.

Income Splitting – Prior to the amendments to the *Income Tax Act,* it was a common planning technique to establish lifetime trusts in a Will for the benefit of a spouse, child or grandchild who is in a high tax bracket. Under the former rules, income could be retained in the trust and taxed at graduated rates, rather than being taxed in the hands of the beneficiary. This permitted an income splitting opportunity for high net worth families. Existing estate plans including such trusts should be reviewed with the foregoing changes in mind, as the income splitting benefit has been significantly reduced.

Disability Planning – Persons under a disability often receive government benefits. If such person were to inherit a large sum, such benefits may be reduced, in whole or in part, as a result of the inheritance. For this and other reasons it is common to establish a testamentary trust for a disabled person in a Will. One of the exceptions to the new tax rules for income retained in a testamentary trust is with respect to a Qualified Disability Trust ("QDT"). QDT's are entitled to be taxed at graduated rates. There are technical requirements that must be satisfied in order for a testamentary trust to be considered a QDT. For example, if anyone other than the "electing beneficiary" (i.e. the disabled person) receives capital from the trust in a given year, there may be a recovery tax payable. Testamentary trusts for disabled persons that were drafted prior to the new tax rules may permit capital encroachment for the benefit of other persons. Accordingly, existing estate plans with such trusts should be reviewed with the foregoing changes in mind.

As a result of the significant changes in estates laws in recent years, it may be necessary to revise an existing estate plan that was made in accordance with the relevant laws at the time the plan was implemented. It is recommended that an estate plan be reviewed at least every three years, even if there have not been any significant changes in family or personal circumstances.

The Personal Balance Sheet

As you navigate the roadmap of life, the amount of financial resources available to you to help you go where you want and do what you want will vary. Your success, in some part, will depend on how well you adapt financially to milestone life events that you encounter along the way as you balance your decisions between saving, investing, borrowing, and spending. Think of these decisions as it relates to your finances as your personal balance sheet.

The choice between borrowing and spending money may depend on your priorities: you can enjoy it today and pay for it tomorrow, or you can make a sacrifice today for tomorrow's pleasure. However you choose to use your money, you will have to regularly decide if it is better to spend extra cash flow on material items that are currently of interest, to pay down debts or invest for your future.

A survey by BMO Wealth Management dated April 2016, revealed that Canadians have three main financial priorities: reducing or eliminating debt (30%), investing effectively and tax efficiently (24%) and saving more (23%). Spending on personal needs or goals came in at just 4%. Not surprisingly, those age 18-34 favoured saving more, people age 35-54 focused on reducing or eliminating debt and those age 55 and over prioritized investing effectively and tax-efficiently.

Still, the desire to "have it all" can take its toll on health and happiness. According to the survey, Canadians have many financial fears: not being able to save or invest towards financial goals (29%), having more debt than they can repay (25%), outliving their accumulated savings (21%), a negative global economic event (14%), not being able to save due to job loss (11%), a long-term downturn in the stock market (10%) and declining home values (7%). To help overcome these fears, we can draw on the approach taken by successful business owners.

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Life stages affect the balance sheet

Just as a small business owner must adapt to changes in the business lifecycle in order to sustain success, it's critical to employ the same entrepreneurial drive and focus to achieve similar successes with your own personal finances. Is it better to purchase a luxury product, make a payment towards a debt, or invest towards a financial goal?

Your current stage in life will have an impact on the financial decisions that you make about borrowing, spending, saving and investing. For instance:

Early adulthood years – Short-term savings such as TFSAs are important, but having a plan in place to achieve longer-term goals – such as buying a home or reducing debt – provides a greater opportunity for increased future wealth, especially if the plan incorporates a regular savings component that invests a little from each pay period. By establishing a budget that focuses on saving and reducing borrowed amounts, as opposed to spending on current desires, it's possible to achieve these goals more quickly.

Parenting – From schooling, sports and music lessons to saving for post-secondary education through RESPs, parents decide how much of the family's financial resources to allocate to their children's wants and needs. Giving kids cash gifts for birthdays and holidays, and getting that first credit card, are opportunities for parents to teach their children about the importance of balancing between spending on current wants and the need to save, invest and manage borrowing effectively. Knowledge passed down from parents and grandparents can help children grow and bloom into financially responsible members of society.

Divorce – Divorce may shrink the size of the family balance sheet through division of assets and liabilities but professional fees add up quickly. If divorce occurs, reevaluate your financial circumstances and reestablish control. This is especially true for the spouse that may not have been involved in the family's financial affairs during the marriage. A financial professional can help you get organized and back on track financially through this difficult period.

Retirement – People approaching retirement may be earning more income than is needed to pay ongoing expenses. It may be the time to reassess spending, borrowing, saving and investing. One of the goals is to have a consistent cash flow or income stream that will help meet ongoing and future financial requirements. Reducing expenses in retirement is also important to help make accumulated savings last a lifetime. Consider scaling back on financial support paid to younger family members, especially if funds are limited.

Financial steps to achieve financial goals

There are a number of strategies that can help to achieve financial goals with greater tax efficiency when investing including taking advantage of RRSPs, Spousal RRSPs and RESPs to earn tax-sheltered growth, or a TFSA to earn tax-free growth. Earning tax-efficient income, such as dividends from Canadian companies, or capital gains from equities, also helps to grow investments more quickly.

An emergency fund helps in situations where unplanned expenses have to be paid for or income is restricted. Funds should be easily accessible and liquid, and enough should be set aside to cover between three to six months' worth of expenses. Emergency funds can be established in a savings account or a TFSA.

It is encouraging that Canadians are taking positive steps towards growing their balance sheets and securing their financial futures. The BMO Survey found that almost half (48%) have set aside funds towards an emergency fund while 42% use a continuous or automated savings program to save.

Competing pressures require difficult choices: focusing on some things now, with the goal of making other things a priority after higher-ranking priorities are accomplished. It means looking at the financial resources available in the form of income and investments, and allocating these resources towards achieving your personal goals.

While no two individuals experience the same sequence of life events, it is important to plan for likely events and be ready to adjust your financial plan to changing circumstances so you can manage all aspects of your personal balance sheet, including balancing saving, investing, borrowing and spending activities over your lifetime. It is important that you and your advisor work together to discuss your personal balance sheet, to make good financial decisions, and adapt when necessary to help you achieve your financial goals. Let's discuss and please let me know if you would like a copy of the BMO Wealth Report titled *The Personal Balance Sheet*.

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