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IMPLICATIONS OF THE NEW ESTATE DONATION RULES INTRODUCED BY BUDGET 2014

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A. INTRODUCTION

Where charitable gifts are made as a result of a donor's death, tax relief under the *Income Tax Act* ("ITA") is greater than if a gift was made during the donor's lifetime. As a result, making charitable testamentary gifts is an attractive estate planning tool. Federal Budget 2014 ("Budget 2014") included a number of tax incentives intended to encourage testamentary charitable giving.[1] In particular, these include more flexibility for charitable donations made by will. These new estate donation rules are coupled with new rules regarding how testamentary trusts are taxed. The new rules apply to deaths that occur after 2015. This *Charity Law Bulletin* outlines the current rules, the new rules, and the ensuing implications, including how the new rules can potentially discourage charitable giving rather than encourage it.

Draft amendments to the ITA on the new estate donation rules were released on August 29, 2014. The changes are now embodied in Bill C-43, *Economic Action Plan 2014, No. 2* ("Bill C-43"), which received Royal Assent on December 16, 2014.[2]

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[1] Ministry of Finance, *The Road to Balance: Creating Jobs and Opportunities – Economic Action Plan 2014* (Ottawa: Ministry of Finance, February 11, 2014) [*The Road to Balance*].
[2] *A second Act to implement certain provisions of the budget tabled in Parliament on February 11, 2014 and other measures*, 2nd Sess, 41st Parl, 2013-14 (assented to 16 December 2014). Budget 2014 also introduced other new rules impacting charitable giving, including doubling the 5-year carry-forward period for gifts of ecologically sensitive land to ten years, and removing the exemption for gifts of cultural property made as part of a tax shelter gifting arrangement from the rule that deems the value of a gift to be no greater than its cost to the donor. These changes are contained in Bill C-31, Economic Action Plan 2014 Act, No. 1, which received Royal Assent on June 19, 2014 [*An Act to implement certain provisions of the budget tabled in Parliament on February 11, 2014 and other measures*, 2nd Sess, 41st Parl, 2013-14 (assented to 19 June 2014), SC 2014, c 20]. These rules will not be reviewed in this Bulletin.

B. CURRENT RULES FOR DEATHS BEFORE 2016

1. General Rules

The tax rules governing estate gifts in place before Budget 2014 will continue to apply for gifts that arise as a result of deaths that occur before 2016.

In this regard, subsection 118.1(5) of the ITA deems a gift made by an individual through a will (a "gift by will") to have been made by the individual immediately *before* he or she died.[3] Subsection 118.1(4) of the ITA provides that a gift made in the year of death is deemed to have been made in the year immediately prior to death to the extent that the tax credit for the gift has not been claimed in the year of death.[4] These provisions allow the donation tax credit to be claimed in the individual's terminal tax return or in the year immediately prior to death.

The value of a non-cash donation is based on its fair-market value on the date of death, not the date when the charity received the gifted property. Where the value of the gifted property was changed after death, this may give rise to valuation issues when the charity issues the donation tax receipt.

Where an individual designated a qualified donee (e.g., a registered charity) as the recipient of the proceeds under a Registered Retirement Savings Plan ("RRSP"), Registered Retirement Income Fund ("RRIF"), Tax-Free Savings Account ("TFSA") or life insurance policy, donation tax credits will also be available. In this regard, if the transfer of the gift to the qualified donee occurs within 36 months after death, then the gift would be deemed to be made immediately before the individual's death.

The limits that apply in determining a taxpayer's total donations that are creditable in a year also apply to gifts made by will under subsection 118.1(5). Generally, the maximum amount of donations that may be claimed in a year is 75% of an individual's net income. Subsection 118.1(1) provides that the 75% limit does not apply in the year of the donor's death and the immediately preceding year. Therefore, donations made in the year of the donor's death and the immediately preceding year could be deducted up to 100% of the deceased's income in those years.

[3] RSC, 1985, c 1 (5th Supp) [ITA].
[4] *Ibid*.

On the other hand, where a gift made as a result of a person's death does not satisfy as a gift by will, the tax credit for a gift made by the estate of a deceased person may be claimed by the estate.[5] However, a gift made by an estate may only be entitled to a charitable donation credit pursuant to subsection 118.1(3) up to 75% of the income of the estate.

In some situations, a gift made from a testamentary trust to a charity may not be treated as a gift at all, but may be treated as a distribution in satisfaction of the charity's income interest in the trust or as a distribution in satisfaction of the charity's capital interest in the trust. If a charity is receiving a property distribution in this manner, then neither the deceased nor the deceased's estate can claim a donation credit.

Because of the additional tax benefits of gifts made by will that are available under subsection 118.1(5), determining whether a gift qualifies as a gift by will has been a key consideration in estate planning in order to obtain the desired tax results. However, such a determination has been a complex area because there is little case law dealing with what would constitute a gift by will. The interpretation of this subsection has been, for the most part, in accordance with the position taken by CRA in its various interpretation bulletins, technical interpretations and rulings. The following provides a succinct summary of CRA's position:

> The Canada Revenue Agency has issued many publications outlining its position as to what constitutes a Gift by Will, and in general, requires that: (i) the terms of the will provide for a donation of a specific property, a specific amount or a specific percentage of the residue of the estate; (ii) it is clear from the terms of the will that the executors are required to make the donation; (iii) the estate is in a position to make the donation after the payment of debts; and (iv) the donation is actually made.[6]

Conversely, CRA would generally determine that a gift is made by the estate where the estate trustee has the discretion to determine the amount of gift, whether a gift is to be made, and the charity to which to make the gift. However, CRA does not appear to have a systematic policy on the requirements of what

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[5] In some situations, a gift made from a testamentary trust to a charity may not be treated as a gift, but may be treated as a distribution in satisfaction of the charity's income interest in the trust or as a distribution in satisfaction of the charity's capital interest in the trust. See M. Elena Hoffstein, "Legal Analysis," in "Making donations through a will or trust: Struggling with CRA interpretations" (Fall 2004) 4:1 *Step Inside*; and D Bruce Ball and Brenda R Dietrich, "Bequests and Estate Planning in Personal Tax Planning" (1999) 47:4 *Canadian Tax Journal*, 995-1018.

[6] M. Elena Hoffstein and Laura West, "Federal Budget 2014 and Changes to Testamentary Charitable Giving" *Charity Talk* (14 October 14 2014), online: <http://www.cba.org/CBA/sections_charities/news2014/budget2014.aspx>. For more information, see also Laura West, "Gifts By Will" *Healthcare Philanthropy: Check-Up 2013* (11 June 2013), online: <http://goo.gl/DkRvUB>.

would qualify as a gift made by will or a gift by the estate. Rather, CRA has dealt with this on a case-by-case basis.

Another problem with the estate donation rules in the ITA prior to Budget 2014 was that they were not flexible enough regarding when a donation tax credit was available. This often led to situations where a donation tax credit could be available in years when there were insufficient taxes owing to make use of the credit. Consequently, the estate could be unable to match tax liabilities with available donation credits.

2. Spousal Sharing of Donation Tax Credits

CRA's current practice is to accept gifts made by the spouse or common-law partner of a deceased individual as part of that individual's "total charitable gifts" under subsection 118.1(1) of the ITA.[7] In this regard, subsection 118.1(3) of the ITA allows an individual to claim a donation tax credit with respect to gifts made in the taxation year. It is CRA's administrative practice to accept gifts made by the spouse or common law partner of that individual as part of an individual's "total charitable gifts" as defined in subsection 118.1(1) of the ITA. This policy is premised on the recognition that generally donations made by one member of the family unit is tacitly a donation made on behalf of the family unit, regardless of the name necessarily given for purpose of the supporting receipt. Consequently, the policy allows for the most beneficial use of the donation for tax credit purposes between spouses and common-law partners. This policy presumes that a spousal or common-law partnership existed at the time of the donation.

CRA's policy also permits similar sharing of donation credits between spouses on death. As explained above, subsection 118.1(5) of the ITA provides that charitable gifts made under an individual's will are deemed to have been made by the individual in the year of death and not by the estate. It is CRA's current policy that assuming a spousal or common-law relationship existed at the time of death and a donation is made in accordance with the terms of a deceased's will, the surviving spouse and the executor(s) can arrange a tax credit claim that is most beneficial to both parties. This allows the surviving spouse to have the option of claiming the donation on his/her return in the year in which the other spouse died.

[7] CRA document number 2010-0372621E5, (26 October 2010).

C. NEW RULES FOR DEATHS AFTER 2015

1. General Rules

Budget 2014 introduced new rules to govern testamentary gifts as a result of deaths that occur after 2015. Under these rules, all estate gifts (regardless of whether they would otherwise be categorized as gifts by will or gifts by the estate under the old regime) will be deemed to be made by the estate at the time at which the gift property is transferred to a qualified donee. The same deeming rules will also apply to designated donations (gifts made through RRSPs, RRIFs, TFSAs and life insurance policies).

As such, the value of a non-cash donation will be based on its fair-market value on the date of the transfer, rather than the date of death as in was under the previous regime.

The new rules will provide greater flexibility in claiming donation tax credits if the gift meets all of the following requirements:

- The gift must be made by the deceased's "graduated rate estate."
- The gift must be transferred to a qualified donee within the first 36 months after the individual's death. This requirement coincides with the fact that an individual's estate only qualifies to be a graduated rate estate for 36 months after death.
- The property must have been received by the estate on and as a consequence of the individual's death or have been subtitled for such property.

To provide flexibility regarding the tax treatment of such gifts, the new rules will allow the estate trustee to allocate the donation made by will among any of the following: (a) the taxation year of the estate in which the donation is made; (b) an earlier taxation year of the estate; (c) the terminal or last taxation year of the deceased person, or (d) the year before the terminal year of the deceased person.[8] Since the graduated rate estate can only exist for 3 years, this means that the estate trustee can allocate the gift within a maximum of 5-year time frame, being 2 years prior to death and 3 years after death.

In this regard, Budget 2014 introduced a new concept of a "graduated rate estate" (a "GRE"), which is an estate that arises on and as a consequence of the death of an individual, qualifies as a testamentary trust, provides for the social insurance number of the deceased individual on the estate's tax return, and is

[8] *The Road to Balance, supra* note 1 at 333.

designated by the estate as a GRE in its first estate tax return that ends after 2015. An estate will only qualify to be a GRE for 36 months from the date of the individual's death. Only one estate can be designated as the GRE for a deceased individual. The GRE will be taxed at the graduated tax rate and can have an off-calendar year, among other features. This means that gifts that qualify for the new estate donation rules must be made by GREs. Other than GREs and "qualified disability trusts",[9] all other trusts (including testamentary trusts that do not qualify as GREs, estates and *inter vivos* trusts) will be taxed the flat top marginal rate, must have a calendar year end, must remit quarterly instalments, cannot claim the $40,000 basic exemption for alternate minimum tax, and will be subject to Part XII.2 tax on certain income.[10]

The current rule that donations made in the year of the donor's death and the immediately preceding year could be deducted up to 100% of the deceased's income in those years will continue to apply. An estate will continue to be able to claim a donation tax credit in respect of other donations in the year in which the donation is made or in any of the five following years.

Specifically, subsection 118.1 has been amended to effect these new rules. As well, paragraphs 38(a.1)(ii), 38(a.2)(ii) and 39(1)(a)(i.1) will also be amended in relation to testamentary gifts of securities, ecological gifts and gifts of cultural property.

2. Spousal Sharing of Donation Tax Credits

Spousal sharing of charitable gifts is now addressed in the ITA as amended by Bill C-43 by amendments to the definition of "total charitable gifts" of an individual in subsection 118.1(1) of the ITA for 2016 and subsequent taxation years. In this regard, if an individual is not a trust, clause 118.1(1)(c)(i)(A) provides that the eligible amount of "total charitable gifts" includes the amount of a gift made to a qualified donee by an individual or the individual's spouse or common-law partner in a taxation year or any of the five

[9] A "qualified disability trust" is a trust with beneficiaries who qualify for the disability tax credit.
[10] Budget 2014 also introduced new tax rules on the taxation of trusts. A review of these rules is outside the scope of this article. For a review of how these rules negatively impact the administration of estates and estate planning, see: M. Elena Hoffstein and Pearl Schusheim, "New Testamentary Tax Rules" presentation to the Jewish Foundation Professional Advisory Committee Seminar (18 November 2014); Tax Insights from High Net Worth/Private Company Services, "New tax rules for testamentary trusts: The bad and the good (and some surprises)" Issue 2014-34, PricewaterhouseCoopers, online: <http://www.pwc.com/en_CA/ca/tax-insights/publications/pwc-new-tax-rules-for-testamentary-trusts-2014-09-en.pdf>; and Lisa Heddema, Angela Ross and Pamela Cross, "Beware: A New Era in Estate Planning, Qualified Disability Trusts, Graduated Rate Estates, Life Interest Trust Taxation" STEP Canada, Webcast (14 November 2014).

preceding taxation years. This practice is consistent with CRA's current administrative practice explained above for gifts made during one's lifetime.

However, clause 118.1(1)(c)(i)(C) provides that gifts made by a graduated rate estate can be claimed on the deceased individual's tax return for the year of death or the immediately preceding year. In a recent technical interpretation released by CRA, CRA takes the view that this clause is more limited in scope and does not include gifts made by the graduated rate estate of a spouse or common-law partner.[11] CRA therefore concluded that, given the new amendments, its current administrative practice allowing gifts made by an individual's will to be claimed by the deceased individual's spouse will no longer apply for deaths occurring after 2015.

D. IMPLICATIONS OF NEW RULES

The new estate donation rules provide greater flexibility in a number of respects, however there are many unanswered issues, and concerns still remain.

One of the welcome changes of the new estate donation rules is the flexibility for estate trustees to allocate the charitable tax credits for charitable gifts over a maximum of 5 years (i.e., 2 years before death and 3 years of the GRE after the death of the taxpayer).

Another welcome change is that the new rules provide greater certainty on the date of a testamentary gift by prescribing that the date of the gift is the date when the gift is received by the charity. Under the old regime, the date of a gift by will is generally the date of death, regardless of when the gift is received by the charity. In practice, the old regime may create hardship in certain situations, especially where the value of the property had depreciated by the time the charity received the gifted property. As such, the new rules would provide greater certainty for charities when they issue donation receipts for testamentary receipts.

The fact that all testamentary gifts will be deemed to be gifts made by the estate appeared, at first blush, to be a welcome change because the proposal avoided the need to determine whether a gift is a gift by will or a gift by estate as was required under the old regime. However, the changes did not expressly clarify this issue. As such, it would be preferable for the ITA to expressly clarify that the new rules are intended to

[11] CRA Document #2014-0555511E5, (27 January 2015).

apply to all testamentary gifts regardless of whether they qualify as gifts by will or gifts by estate under the current regime.

The new rules require that the gifted property must have been received by the estate on and as a consequence of the individual's death or have been subtitled for such property. This will in turn mean that the estate cannot borrow funds in order to make a qualifying estate gift. This may cause hardship in certain situations, for example where the estate's funds are somehow tied up for more than 3 years and the estate would be prevented from borrowing funds to make the gifts before the 36 month limit runs out.

Another challenging issue in applying the new estate donation rules is that only gifts made within 36 months after death will be eligible for allocation within a 5 year time frame. This will impose greater pressure on estate trustees to administer the estate as soon as possible within this time frame if they want to take advantage of the greater tax benefits under the new rules. However, in practice, there are many situations where a gift may not be able to be made within this period and the 36 month period does not do justice to taking these circumstances into account. Examples of such circumstances include the time required to obtain a clearance certificate (which may take a year or more in some jurisdictions), the time required to resolve estate disputes or litigation, the time required to seek direction from the court to clarify the terms of the will, or the time required to dispose of an illiquid asset (such as real estate, art work, or private company shares). If an estate cannot effect the transfer of a gift within 36 months, the donation tax credit is only available to the estate for the year of the transfer. There are various potential solutions suggested by the sector to address this problematic issue. For example, CRA could be given an administrative power to allow it to extend the 36 month period upon application to CRA,[12] or the ITA could be amended to remove the 36 month distribution requirement from estate gifts all together. It has also be suggested that where an individual does not anticipate that his or her estate could make the desired testamentary gift within the 36 month period, there might be an increase in the use of private foundations or short-term or bridge donor advised funds in estate plans.[13]

[12] Canadian Association of Gift Planners, Submission to the House of Commons Standing Committee on Finance (1 August 2014) online: <http://www.parl.gc.ca/Content/HOC/Committee/412/FINA/WebDoc/WD6615327/412_FINA_PBC2014_Briefs%5CCanadianAssociationOfGiftPlanners-e.pdf>; Canadian Association of Gift Planners, letter to Department of Finance, (29 September 2014).

[13] Malcom Burrows, "Tax Deadlines & Charities," *All About Estates* (12 December 2014), online: <http://www.allaboutestates.ca/estate-planning/tax-deadlines-charities/>.

Another highly problematic issue is that the new rules do not specifically deal with the treatment of gifts to a charity on the death of an intervening life interest (commonly referred to as charitable remainder trusts). In the case of qualifying spousal trusts, the donation will be deferred until the death of the surviving spouse. Such a gift can qualify as a gift by will under the current regime if the trustees have no right to encroach on the capital in favour of the life tenant. Although a residual interest in a charitable remainder trust is a property interest that can be transferred to a charity within three years of death, it is only that property interest that is transferred to the charity on death, while the actual underlying property of the charitable remainder trust cannot be transferred until after the death of the life tenant.

Last but not least, CRA's current administrative practice allowing gifts made by an individual's will to be claimed by the deceased individual's spouse will no longer apply for deaths occurring after 2015.

With the new estate donation rules not applying until death occurring after 2015, it remains to be seen whether the ITA will be amended in 2015 to address these issues.