Considerations in Cross-Border Giving Between Canada and The U.S.

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CAGP-ACPDP Conference
April 25, 2008

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Introduction

• The operations of many charities have become increasingly international in scope
• Donors’ philanthropic ideals are more international in scope as well
• Focus today – gifts from U.S. donors to Canadian charities
• Application of Canada-United States Income Tax Convention (1980) to cross-border gifts
Summary

• Overview of U.S. gifts and estate law
• Gifts to Canadian charities under the Canada-U.S. Treaty
• Common gift vehicles in the U.S.
  – Charitable remainder trust
  – Gift annuities

Overview of U.S.

Estate and Gift Tax Law
Gifts in USA

100% of the “present value” of gifts to charities, defined by the IRS code as 501 (c) 3 organizations, can be deducted from taxable income in the year of the gift subject to the following limitations:

– Appreciated Property limited to 30% of Adjusted Gross Income in any one year
– Cash or non-appreciated property limited to 50% of Adjusted Gross Income in any one year

Unused deductions may be carried forward for five years.

Gifts-Exceptions

Deduction for gifts of tangible personal property (art, stamp collections, jewelry, etc.) limited to donor’s cost basis unless “related use” can be established.

Example: If a donor gave art to an art museum the deduction would be the full “fair market value”, because donor can reasonably expect the museum would display the art.
Gifts-Exceptions

Unrelated use. If the donor gave art to a health charity which does not have an art museum, e.g. American Cancer Society, there would be no “related use” and tax deduction is limited to donor’s cost basis.

How to Determine “Present Value”

Publicly traded equities defined as the median price between the high and the low on the date title is transferred from the donor to the charity.

Illiquid assets (real estate, closely held stock, stamp collections, etc.) value determined by a “qualified appraiser”
Estate Tax in USA

Estates* are subject to a progressive federal estate tax, levied at rates of 30% - 45%. The “personal exemption” is $2 million in 2008, and it will rise in the future to:

- 2008 $2,000,000
- 2009 $3,500,000  (99.8% estates exempt)
- 2010 Repeal of estate tax for 1 year
- Jan 1, 2011 Rates of 2001 return!

*100% of all bequests to a spouse or to charity are tax exempt

Gift Tax in USA

Gift tax in USA
Same rates as estate tax, but lifetime exemption fixed @ $1,000,000 per person plus annual exemption of $12,000 per donor per donee per year. All gifts to a spouse or a charity are free of tax.

Note – In Canada, no federal estate tax*, provincial probate fees levied

* Tax credits in Canada up to 100% of net value of deceased in year of death with one year carry-back
Gifts To

Canadian Charities under

the Canada-U.S. Treaty

Reciprocal Relief under the Treaty

for Cross-Border Gifts

Gifts to Canadian charities - Reciprocal relief under the Treaty [Article XXI(5)]
- Colleges and universities in Canada
- Gifts to other Canadian charities, but limited to Canadian-source income
- Bequest

Gifts to U.S. charities - Reciprocal relief under the Treaty [Article XXI(6)]
- Colleges and universities in the U.S.
- Gifts to other U.S. charities, but limited to U.S.-source income
- Bequest – but does not apply in Canada in practice
Gifts from U.S. Donors to Canadian Charities

- Charitable contributions by U.S. donors to organizations created or organized in Canada or the U.S. do not provide donors with the benefit of tax deduction.

- Relief:
  - Article XXI(5) of the Canada-U.S. Treaty
  - Gifts to some Canadian colleges and universities
  - Bequests to Canadian charities

- Unless the Canadian charity has a “friends” organization in the U.S. to receive gifts from U.S. donors
  - “Friends” organizations are separate public charities in the U.S.
  - Cannot be mere conduit, it must exercise its own control over its assets and gifts made to it
(1) Gift to Canadian Universities

- Under Article XXI(5) of the Treaty, a U.S. donor may make a contribution to a Canadian college or university at which the donor, or a member of the donor's family, is or was enrolled.

- Such contributions will not be restricted to the donor's Canadian-source income, although the usual U.S. donation limits will still apply.

- “Family” means an individual’s “brothers and sisters (whether by whole or half-blood, or by adoption), spouse, ancestors, lineal descendants and adopted descendants.” This would include donations made by students, alumni and their family members.

- Similar reciprocal relief is provided under Article XXI(6) of the Treaty for donations by a Canadian donor to a U.S. college or university at which the donor, or a member of the donor's family, is or was enrolled.
(2) Gifts to Other Canadian charities

- A U.S. donor who makes a charitable contribution to a Canadian charity is entitled to claim a charitable deduction under Article XXI(5) of the Treaty - the Canadian charity must be resident in Canada and is generally exempt from Canadian tax that could qualify in the U.S. to receive deductible contributions if it were a resident in the U.S.

- Comparison - Similar relief for donations by Canadian donors to U.S. charities pursuant to Article XXI(6) of the Treaty

(a) Residency Requirement

- In order for a Canadian charity to qualify for the benefits offered by Article XXI(5) of the Treaty, the Canadian charity must be a “resident of” Canada.
  
- Article IV(1) of the Treaty defines “resident of a contracting state” to mean any person who, under the laws of that state, is “liable to tax”.

- Article IV is understood to include … a not-for-profit organization that was constituted in that state and is, by reason of its nature, generally exempt from income taxation in that state.
Two requirements:
- Liable to tax in Canada
- Constituted in Canada

1) Liable to tax in Canada
• It has been the long-standing position of CRA that, to be considered “liable to tax” for the purposes of the residence article of Canada’s tax treaties, a person must be subject to the most comprehensive form of taxation as exists in the relevant country - means full tax liability on worldwide income

However, charities are often not subject to tax in the contracting state
  - CRA confirmed its long standing position
  - There may be situations where a person’s worldwide income is subject to a contracting state’s full taxing jurisdiction but that state’s domestic law does not levy tax on a person's taxable income or taxes it at low rates
  - The determination of residency for the purposes of a tax treaty is a question of fact
2) Constituted in Canada

- In Canada, registered charities that are resident in Canada are either created or established in Canada.
- A corporation incorporated in Canada after April 26, 1965 are deemed to be a resident in Canada for tax purposes, regardless of whether the corporation is managed or controlled within or outside of Canada.
- Where a registered charity is constituted as a trust, its residency is determined by where the trustees reside – or where the majority of the trustees resides if they could make decision by majority decision.

Comparison

- For U.S. charities to claim benefit under Article XXI(6) of the Treaty, the 1995 technical explanation to the Treaty indicates that “not-for-profit organizations” in Article XXI(6) are organizations such as those listed in section 501(c) of the Code.
- Since entities organized outside of the U.S. are permitted to apply for tax-exempt status under section 501(c)(3) of the Code, such exemption does not necessarily imply that the entity is resident in the U.S.
(b) Exempt from Cdn. tax and qualified in the U.S. to receive deductible contributions

- The Canadian charity must be (1) generally exempt from Canadian tax and (2) could qualify in the U.S. to receive deductible contributions if it were resident in the U.S.

- CRA indicates that they accept any organization that qualifies under section 501(c)(3) of the Code will meet this test for purposes of Article XXI(6)

- In order to benefit from Article XXI(5), registered charities in Canada are exempt from paying taxes and thereby would meet the first requirement

- A registered charity must be organized and operated exclusively for one or more heads of charitable purposes as recognized at common law by the courts, namely relief of poverty, advancement of education, advancement of religion, or other purposes beneficial to the community in a way the law regards as charitable – very broad
• However, the broad array of organizations that meet the first requirement would be limited to those that qualify in the U.S. to receive deductible contributions if they were resident in the U.S.

• Under the Code, for a “charitable contribution” to be deductible, it must involve a transfer of money or property to a qualified recipient as defined in section 170(c) of the Code – limited to those entities that are organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition or for the prevention of cruelty to children or animals would meet both requirements.

• **Comparison** - the application of Article XXI(1) of the Treaty in relation to the exemption of income earned by a charity from income tax in the other contracting state is also restricted to “religious, scientific, literary, educational or charitable” organizations.
Recognition Procedure

- Letter between the U.S. and Canada, September 26, 1980
  - Competent authority of each contracting state would review the procedures and requirements for an organization of the other contracting state
    - In order to establish as a religious, scientific, literary, educational or charitable organization entitled to exemption under Article XXI(1) of the Treaty, or
    - In order to establish as an eligible recipient of charitable gifts or contributions referred to in Articles XXI(5) or XXI(6) of the Treaty

  - A mutual agreement has been entered into between Canada and the U.S. to implement the understanding confirmed in the 1980 letter
  - Recognized religious, scientific, literary, educational or charitable organizations that are organized under the law of either the U.S. or Canada will receive recognition or exemption without application in the other country
- Canadian charities wishing to seek benefits under both Articles XXI(5) and XXI(1) of the Treaty can automatically be recognized by the U.S.

- From CRA’s perspective:
  - Automatic recognition procedure is only available for U.S. charities seeking Treaty benefits under Article XXI(6) of the Treaty but not under Article XXI(1)
  - To seek benefit under Article XXI(1) of the Treaty, U.S. charities are required to submit an application to CRA

(3) Bequests to Canadian Charities

- U.S. imposes an estate tax on death, while Canada applies an income tax on capital gains deemed realized at death rather than an estate tax
- Article XXIX B of the Treaty is intended to coordinate the operation of the death tax regimes of the U.S. and Canada
- Article XXIX B (1) provides that a Contracting State shall accord the same death tax treatment to a bequest by an individual resident in one of the Contracting States to a qualifying exempt organization resident in the other Contracting State as it would have accorded if the organization had been a resident of the first Contracting State
• The organizations covered by this provision are those referred to in Article XXI(1) of the Treaty – i.e. “religious, scientific, literary, educational or charitable” organizations
• A bequest by a U.S. citizen or U.S. resident to such an exempt organization generally is deductible for U.S. estate tax purposes under section 2055 of the Code, without regard to whether the organization is a U.S. corporation

• However, if the deceased is not a U.S. citizen or U.S. resident, such a bequest is deductible for U.S. estate tax purposes, under section 2106(a)(2) of the Code, only if the recipient organization is a U.S. corporation
• Under Article XXIX B(1) of the Treaty for U.S. estate tax purposes, a resident of Canada who was not a U.S. citizen immediately before death and who bequeaths property to a Canadian registered charity will be treated as if he or she had bequeathed property to a charity organized in the U.S.
However, paragraph 1 does not allow a deduction for U.S. estate tax purposes with respect to any transfer of property that is not subject to U.S. estate tax.

Consequently, the amount of such a bequest will be allowed as a deduction for U.S. estate tax purposes under the Code provided that the property so bequeathed is part of the assets that would be included in the gross estate situated in the U.S. of the deceased person.

Comparison - Since there is no estate tax in Canada, Article XXIX B(1) of the Treaty would have no application in Canada. Where a deceased person who was a Canadian resident and not a U.S. citizen immediately before death bequeaths property to a U.S. tax-exempt charity, Article XXI(6) of the Treaty would apply and Article XXIX B(1) of the Treaty would not apply. If the deceased has no U.S. source income in the year of death or in the year immediately preceding the year of death, no donation credit will be allowed.
Comparison - Non-Reciprocal Relief under the *Income Tax Act* for Gifts to U.S. Charities

- Canadian commuter donors
- Prescribed universities outside of Canada
- United Nations
- Gifts by the Queen

**a) Canadian donors who are commuters**

- The person resides in Canada near the Canada-U.S. border
- The person commutes to his or her principal place of employment or business in the U.S., from where the person derives his/her chief source of income
- The donation is made to a U.S. religious, charitable, scientific, literary or educational charity created or organized under the laws of the U.S. - same as those entities that qualify under Article XXI(1) of the Treaty (but not all 501(c)(3) charities)
b) Prescribed universities

- Canadian donors are permitted to make charitable donations to foreign universities prescribed to be a university if their student body ordinarily include students from Canada
- Pursuant to Regulation 3503, these universities are those named in Schedule VIII to the *Income Tax Regulations*
- The qualifying entities must be the universities themselves, and that an entity, e.g., a centre or a foundation, whose activities and funds are dedicated to achieving the goals or the activities of a particular university would not qualify

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c) Donee of Her Majesty in the Right of Canada

- Canadian donors can make donations to charitable organizations outside of Canada to which Her Majesty in right of Canada has made gifts in the current year or in the previous calendar year
- The list is kept by CRA - last revised on March 3, 2008
- CRA is responsible for determining whether the entity receiving a gift from the federal Crown is a “charitable organization” according to Canadian law, and whether the payment to the foreign entity is a “gift” at law
d) United Nation and its agencies

- Canadian donors are permitted to make charitable donations to the United Nations and its agencies.
- U.S. charities that are considered to be “agencies” of the United Nations would fall within this category.
- It is not clear what entities are agencies of the United Nations for the purpose of the definition of qualified donees.

Common Gift Vehicles

in the U.S.
Common Gifting Strategies

- Bequests are still the most popular planned gift in both Canada and the USA
- Planned gifts that reduce capital gains taxes are becoming more popular in both countries
- In Canada, this evolution began with the reduction in capital gains taxes on gifts of appreciated public securities

Who Benefits and How?

All charitable trusts and gift annuities are split interest gifts that benefit both the donor and the charity

<table>
<thead>
<tr>
<th>Donor</th>
<th>Charity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bequest</td>
<td>Asset removed from estate</td>
</tr>
<tr>
<td>CRUT</td>
<td>Income + Tax deduction</td>
</tr>
<tr>
<td>CGA</td>
<td>Income + Tax deduction</td>
</tr>
<tr>
<td>Lead trust</td>
<td>Tax deduction +</td>
</tr>
<tr>
<td></td>
<td>no tax on asset appreciation</td>
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</tbody>
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Charitable Vehicles to Reduce Capital Gains Tax in USA

Because of the scheduled increase in personal exemption from estate tax, American gift planners have shifted their focus from reducing estate tax to minimizing the capital gains tax for living donors*. The most popular vehicles are:

- Charitable Remainder Trusts (many types)
- Charitable Gift Annuities (CGA)

* In the USA, the cost basis of all appreciated assets is stepped up to market on the death of the owner

Charitable Trusts in USA

Remainder trusts: asset given to charity; income paid to donor et al for one or more lifetimes or term of years. Payout must be 5%--50%

- CRUT (similar to Canadian charitable trusts)
- NIMCRUT net income trust (pays out only the “income” earned by trust)
- FLIP CRUT (begins as net income and flips to CRUT after a “trigger event”. Specifically designed for real estate gifts
Charitable Remainder Trusts

All charitable remainder trusts in USA are tax exempt.
1) Tax deduction equals the “present value” of the remainder gift to charity
2) Assets can be sold and reinvested inside the trust without generating any income or capital gain taxes
3) Trust payments are taxable to the individual who receives them
4) At end of the trust whatever remains is donated to charity

CHARITABLE UNITRUST

Generous Donor - Age 70  Spouse - Age 70

Property $100,000

5% Unitrust

Principal $100,000

Charity $184,536

Two Lives

Give asset, sell Tax-Free. Bypass up to $20,000 gain may save $3,000. Income tax deduction of $41,987 may save $11,756.

2. UT annual income $5,000. Increased income $1,000 over prior $4,000 income. Estimated income in 21.8 years $148,309. Effective pretax rate 5.67%.

3. If trust earns 7.85%, pays 5 then grows by 2.85%. After two lives, trust passes without probate to charity.
A More Complicated and Realistic CRUT Illustration

Assumptions:
Generous Donor Couple (70 & 70) donate a piece of real estate worth $500,000 (basis = $200,000) to a 6% two-life CRUT. After deducting 10% sales expenses I used actual S&P 500 returns for the last 22 years to predict the income stream they will receive.
STANDARD UNITRUST

Generous Donor - Age 70  Spouse - Age 70

Initial Amount
$500,000

Principal
$450,000

Charity
$872,200

6% Unitrust

Standard Payout Model

Two Lives

Transfer and sell tax-free.
Bypass up to $250,000 gain may save $37,500. Income tax deduction of $178,070 may save $49,860.

2. Unitrust Income of 6% to donors for two lives. Annual income at payout $27,000. If trust earns 5.03%, pays 6% income during two lives, total lifetime income is $1,037,889.

3. Income for estimated period of 21.8 years. After two lives, trust principal paid to charity.
Points to Note about CRUT Income to Donors

1) Both selling expenses (e.g. brokerage commission on real estate) and trustee expenses will be deducted from the corpus and will reduce income paid to the donor. Net proceeds of sale is only $450,000.

2) CRUT Income rises over time from $27K in year 01 to $56K in year 21.

3) CRUT income may be highly variable year-to-year especially if a large proportion of the corpus is invested in equities. Note-income falls by 48% from year 14 to year 17!

Points to Note about CRUT Income to Donors

4) If trust corpus is invested primarily in bonds returns will be low and the value of the charity’s remainder interest may fall below the tax deduction.

5) Make certain the donors are comfortable with a variable income stream and can handle short term but sharp declines in CRUT income.
Charitable Gift Annuities (CGA) in USA

- Offered by many American charities
- Legally a contract with the donor (payments are guaranteed by full faith and credit of the charity)
- American Committee on Gift Annuities recommends payout rates: 5.4% (couple aged 60/60) to 11.3% (single 90 year old)
- Annuity rate schedule is adjusted periodically so that ~ 50% of the annuity amount will be a gift for which the donor receives a tax deduction
**Tax Considerations in USA: Charitable Gift Annuities (CGA) and Charitable Remainder Trusts**

- Can be funded with different assets (cash, stock, bonds, real estate, even personal property)
- Gift is irrevocable
- Tax deduction = gift portion = “present value” of gift
- Tax deduction must equal 10% of trust assets
- Capital gains tax on “gift portion” is forgiven
- Capital gains on “retained portion” is spread over life of income beneficiaries
- CRUT annual payout range: 5%-50%

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**Charitable Lead Trusts**

1) CLTs are the mirror opposite of remainder trusts: Donor gives income to charity and gives property to relatives (family lead trust) or it returns to the donor (donor lead trust).
2) CLTs are relatively uncommon; they represent less than 5% of all charitable trusts.
3) CLTs are becoming more popular because when interest rates are low, as in the present economic environment, the tax deduction for a CLT increases while the tax deduction for a remainder trust or CGA falls.
1) Family lead trusts are established to offset the gift tax when a valuable asset is given to a member of the donor’s family. If the “present value” of the lead payment to charity equals the amount given to family no tax liability is created. In the example above the lead payment of $7,000 per year for twenty years = $140,000 offsets the tax on the whole gift of $100,000.

2) All gain in value of asset after it is donated to the trust passes to the family free of tax.
### Tax Considerations in USA

#### Lead Trust

3) In a low interest rate environment (such as the present) lead trusts are more attractive because the tax deduction increases as the interest rate decreases. CRUTs are exactly the opposite.

4) Grantor lead trusts, in which the asset reverts to the donor after the end of the trust, are used to establish a large tax deduction this year e.g. to offset a large increase in taxable income.

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### Cross-Border Issues

- Charitable remainder trusts
  1) A U.S. donor who donates property to a charitable remainder trust to benefit a Canadian charity
     - The Canadian charity must meet the relief provisions under the Treaty, i.e. U.S.-source income, Canadian college or university from which the Canadian is an alumnus
     - In Canada, since the interest given to the charity is a remainder interest, the amount of the tax credit will be equal to the value of the remainder interest given to the charity
• In order for the Canadian charity to issue a receipt for the remainder interest, the requirements under Canadian law must be complied with:
  – The trust must be irrevocable
  – The charity’s remainder interest in the trust must vest in the charity at the time the property is transferred to the trust
  – the terms of the trust must not provide for a power of encroachment – in order to be able to determine what, if anything, the charity will ultimately receive from the trust

• If the terms of the trust to be established by a U.S. donor do not meet the requirements in Canada, consider naming the Canadian charity’s friends organization as remainder beneficiary
2) A Canadian donor who donates property to a charitable remainder trust to benefit a U.S charity
   • The terms of the trust must comply with Canadian requirements in order that the Canadian donor be entitled to claim the tax credit for having made a valid gift to a charitable remainder trust
   • The U.S. charity must meet the relief provisions under the Treaty or the Income Tax Act, e.g. Canadian-source income, U.S. prescribed university, U.S. college or university from which the U.S. is an alumnus, etc.

   • Gift annuities
     1) For a U.S. donor – to purchase gift annuity from a Canadian charity that meets the relief provisions under the Treaty, i.e. U.S.-source income, Canadian college or university from which the Canadian is an alumnus.
     2) For a Canadian donor - to purchase gift annuity from a U.S. charity that meets the relief provisions under the Treaty or the Income Tax Act, e.g. Canadian-source income, U.S. prescribed university, U.S. college or university from which the U.S. is an alumnus, etc.
Withholding tax issues
Authority to issue annuity
Reporting requirements
For U.S. donors, consider purchasing annuities from “friends” organization of a Canadian charity

Conclusion

• Must work with the rules under the Code and the Income Tax Act
• The Treaty provides some limited relief for charitable gifts
• The use of cross-border charitable remainder trust and gift annuity is complicated and must be carefully planned
• Canadian charities may find it beneficial to establish friends organizations in the U.S.
THANK YOU

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