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A newsletter for CLU designation holders focusing on risk management, wealth creation, and preservation.

How Planned Giving Strategies Fit In with Estate Planning

by Joël Campagna

As we enter 2022, we have just come through prime charitable giving season. Often, at year end individuals review their donations for the year and consider making additional gifts so that the tax benefits are recognized in the current year. A donation made in December of 2021 reduces taxes owing for 2021, and the cash flow benefit of the donation is received by April 30, 2022 (or earlier for those who file their tax returns before the deadline). Since charitable donations are fresh in many people's minds, this can be a great time to speak with your business-owner clients about reviewing their will and estate planning and ensuring that any charitable gifting done in their will is properly structured.

At death a significant tax bill can arise if the individual does not have a spouse to roll their assets and registered plans to. An individual is deemed to dispose of all of their capital property (e.g., shares of private companies, real estate, public company securities) at fair market value immediately before death and thus recognize capital gains. Furthermore, the value of assets held in registered plans such as RRSPs and RRIFs will also be included in income in the year of death. This can result in a significant tax bill.

One way to mitigate this tax bill at death is to have the person's will provide for gifts to charity and claim a donation tax credit in their terminal tax return. The claiming of the donation credit is contingent on several things, including the timing of the donation, the designation of the estate as the graduated rate estate (GRE), and the type of property donated, with special rules governing gifts of a non-qualifying security, discussed in more detail below.

When an estate is a considered the GRE it has the benefit of being taxed at graduated rates for up to 36 months. Another tax benefit that hinges on GRE status is the ability to flexibly use charitable donation credits.

Where a charitable gift is made within 60 months of death and it is made by will, the estate, or by direct designation, if the estate qualifies, or previously qualified as the GRE, there is greater flexibility in claiming the charitable donation tax credits. That is, the charitable donation tax credit can be claimed:

- in the year of the gift by the estate against 75% of net income with a carry forward of five or 10 years (depending on the type of property that is given);
- carried back to the deceased's final (terminal) return for the year of death or the year prior to offset 100% of net income; or
- a prior year of the estate so long as it qualified as the GRE in that year.

To be considered the GRE, the estate must elect GRE status in its first tax return. What if the gift is made before the estate has even filed its first tax return in which it would designate itself as the GRE?

For example, a gift by direct designation (i.e., charity is named as the beneficiary) under a life insurance policy can be fulfilled very quickly. In general, life insurance claims are paid promptly upon receipt of all required documents.

A positive response was received from the Canada Revenue Agency (CRA) in Technical Interpretation #2017-0684481E5. That is, CRA's view was that so long as the estate meets the definition of GRE at the time it files its first return of income, a gift given before filing will be afforded the flexibility described above regarding the use and timing of a donation tax credit.

Another issue that can impact the timing of claiming a donation tax credit as well as eligibility for a donation tax credit is related to the type of property that is donated. Many estate plans contemplate the donation of private company shares at death to mitigate the tax implications arising from the deemed disposition. The ability to claim the donation tax credit is contingent on whether the shares are considered non-qualifying securities (NQSs). An NQS is generally defined in subsection 118.1(18) of the *Income Tax Act*[1] as a share, debt obligation, or other security issued by the donor or a person not dealing at arm's length with the donor. For example, shares of a private company controlled by the donor, their estate, or someone not dealing at arm's length with the donor or their estate would be an NQS.

A gift of an NQS is not recognized as a charitable gift for tax purposes until the charity disposes of the NQS. The charity must dispose of the NQS within 60 months of receiving the gift for the gift to be recognized as a charitable gift at all. When the charity disposes of it, the value of the charitable gift[2] of an NQS is deemed to be the lesser of:

- the fair market value at the time of the original gift, and
- the amount the charity receives "as consideration" on the later disposition, other than consideration that it itself is an NQS

These rules do not apply if the charity is a public foundation or charitable organization with which the donor deals at arm's length.

The recent case of *Odette (Estate) v. The Queen* 2021 TCC 65 involved the gift of an NQS. In this case, the deceased, who died in November of 2012, made a gift by will of an NQS (private company shares held by the deceased) to a private foundation. The shares were transferred to the foundation in December of 2013, and within a few days, the corporation purchased the shares for cancellation in exchange for a $17.7-million promissory note. Since the promissory note was issued by a non-arm's length corporation, it was itself an NQS. Several months later the corporation repaid the promissory note in three tranches totalling $17.7 million of cash. The deceased claimed a $17.7 million charitable tax credit in their terminal return.

For deaths prior to 2016, as in the Odette case, a charitable donation made by will was deemed to be made by the deceased and could offset 100% of net income in the terminal return or the immediately prior year. Whereas gifts made by an estate could only be claimed against 75% of the estate's net income with a carry forward of five or 10 years (depending on the type of property that was given).

The CRA denied the charitable donation credit claimed in the terminal return on the basis that the promissory note issued on the redemption of the shares donated to the charity was itself an NQS and thus excluded from what would be considered consideration. The Tax Court agreed with the CRA and reviewed the NQS rules in the Act, which in 2012 were essentially the same as described above.

The estate argued that the words "any consideration" in paragraph 118.1(13)(c) should include both the promissory note and the cash the charity later received from the corporation on the repayment of the promissory note. The court did not accept this argument. The court looked at the words of the Act, the technical notes when these measures were enacted, and the context of the NQS rules and found the only consideration the charity received at the time of the disposition of the shares (i.e., at the time of the redemption) was the promissory note. The promissory note was an NQS, and consequently, the fair market value of the gift was nil. The court decision was a very bad result for the deceased as the expected terminal return tax savings from the donation credit would have likely been close to $9 million.

Imagine what could have happened here if corporate-owned life insurance was available to redeem the gifted shares. If that were the case, the gift made by will could have been fulfilled within a short timeframe after death and the disposition would have occurred using life insurance proceeds as consideration for the shares. Redeeming the shares with life insurance proceeds rather than a promissory note would have allowed the gift to be claimed in the deceased's terminal return. In addition, the corporation would have received a capital dividend account credit from the life insurance proceeds allowing the survivors to extract tax-free funds from the corporation in the future.

The moral of the story is form matters. Although the foundation ultimately did receive cash in a very short period, the temporary issuance of the promissory note on the redemption of the shares negated the tax benefit of the planning. Furthermore, life insurance can provide immediate liquidity to ensure that a client's estate planning is not frustrated. Now is a great time to speak to your clients about charitable giving as part of their estate planning. ©

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[1] *The* Income Tax Act, *R.S.C. 1985, c.1 (5th Supplement) (as amended) (the "Act"). Unless otherwise stated, all statutory references are to the Act.*

[2] *Pursuant to paragraph 118.1(13)(c) of the Act.*

COMMENT is an informative newsletter targeted to the unique niche that CLU advisors occupy in the financial services industry, with a focus on risk management, wealth creation and preservation, estate planning, and wealth transfer. COMMENT has been an integral part of the CLU environment since 1967.

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