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DYING TO DONATE — DETERMINING CHARITABLE DONATION TAX CREDITS ON DEATH AFTER 2015

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Wolters Kluwer regularly features Dentons Canada LLP articles examining cases and topics of special interest.

In the 2014 Budget, the Department of Finance proposed a number of changes to the taxation of testamentary trusts and estates.[2] While the most significant changes were to the taxation of testamentary trusts,[3] changes were also made to the manner in which the charitable donations tax credit (the "CDTC") could be claimed with respect to charitable gifts[4] made by individuals on their deaths. The Supplementary Information relating to these changes states that the purpose of these amendments is to "provide more flexibility in the tax treatment of charitable gifts made in the context of a death that occurs after 2015".[5]

Currently, subsection 118.1(5) of the *Income Tax Act*[6] deems all charitable gifts made by an individual in his or her will to a qualified donee[7] to have been made by that individual immediately prior to his or her death and may be applied only against tax payable by the deceased. Similar deeming provisions apply to gifts of life insurance proceeds, funds in a registered retirement savings plan, funds in a registered retirement income fund, or funds in a tax-free savings account by way of direct designation ("Direct Designation Gifts") to qualified donees.[8] Under the current legislation, charitable gifts made on death may be applied against tax otherwise payable by the deceased in the deceased's terminal tax return or, if any amount remains unused after that, against tax otherwise payable by the deceased in the taxation year prior to death.

One of the benefits of the current legislation is that the charitable gift is deemed to have been made at the same time the deceased is deemed to have disposed of all of his

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[1] The author is grateful for the input and feedback of Rick Cruickshank Q.C., Partner, Dentons Canada LLP. Any and all errors, oversights, and omissions are the author's alone.

[2] These changes were implemented in S.C. 2014, c. 39 (Bill C-43), which received Royal Assent on December 16, 2014.

[3] These changes will not be discussed in this article, except to the extent that they relate to charitable gifts made as a consequence of death.

[4] Any reference to charitable gifts includes a reference to property described in subparagraph 39(1)(*a*)(i.1) ("cultural gifts") and property described in the definition of "total ecological gifts" in subsection 118.1(1) ("ecological gifts") unless the context otherwise requires.

[5] 2014 Federal Budget, Annex 2 — Tax Measures: Supplementary Information (released February 11, 2014).

[6] All legislative references are to the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.), as amended, unless otherwise specified.

[7] As defined in subsection 149.1(1).

[8] Subsections 118.1(5.1) and (5.3).

or her property.[9] As a result, the executors of the deceased's estate do not have to complete separate valuations for the purposes of the deemed disposition and for the purposes of determining the amount of the charitable gift. Another benefit of the current legislation is that when a person gifts publicly traded securities[10] to a qualified donee, makes ecological gifts, or makes cultural gifts, any capital gain on the disposition of those properties is deemed to be nil.[11] This applies regardless of whether the charitable gift is made during the individual's lifetime or the gift is made under the individual's will.

One significant drawback, however, is that charitable gifts made by an individual in a will cannot currently be applied against taxes payable by the estate nor can the charitable gifts be applied in the deceased's taxation year immediately prior to the taxation year in which the deceased died, except to the extent that there is any excess after the application of the gifts in the year of death.

The proposed amendments released in the Notice of Ways and Means Motion released on October 10, 2014, which received Royal Assent on December 16, 2014, will change the tax treatment with respect to charitable gifts made by an individual as a consequence of that individual's death. The amended legislation will apply to gifts made under a will to a qualified donee and Direct Designation Gifts, where the donor has died after 2015. As set out above, the changes were made with the goal of increasing flexibility with respect to charitable gifts made on death.

The amended legislation will no longer deem all charitable gifts to have been made by the deceased immediately prior to the deceased's death. Instead, all charitable gifts made by the deceased on his or her death will be deemed to have been made by the deceased's estate at the time the property is transferred to the donee.[12] This includes Direct Designation Gifts.[13] While this would seemingly eliminate the deceased's ability to claim the CDTC on his or her terminal tax return or penultimate tax return, the definitions of "total charitable gifts", "total cultural gifts", and "total ecological gifts" have all been amended to allow the executors to allocate the charitable gifts made by the deceased on death between the deceased and the deceased's estate, provided that the deceased's estate is a "graduated rate estate" at the time the gift is made.[14]

An estate will be a "graduated rate estate" of a deceased individual at any time, if:

(a) that time is not more than 36 months after the individual's death;

(b) the estate is at that time a testamentary trust;

(c) the individual's Social Insurance Number (or if the individual had not, before the death, been assigned a Social Insurance Number, such other information as is acceptable to the Minister) is provided in the estate's return of income under Part I for the taxation year that includes that time and for each of its earlier taxation years that ended after 2015;

(d) the estate designates itself as the graduated rate estate of the individual in its return of income under Part I for its first taxation year that ends after 2015; and

(e) no other estate designates itself as the graduated rate estate of the individual in a return of income under Part I for a taxation year that ends after 2015.[15]

If the estate is a graduated rate estate at the time the gifted property is transferred, the executors of the deceased's estate can allocate the gift among any of:

(a) the last two taxation years of the individual;

(b) the previous taxation years of the estate; and

(c) the taxation year of the estate in which the gifted property is transferred.

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[9] Subsections 70(5) through (5.2).

[10] That meet the requirements set out in paragraph 38(*a*.1).

[11] Paragraphs 38(*a*.1) and (*a*.2) and subparagraph 39(1)(*a*)(i.1).

[12] Subsection 118.1(5), effective 2016.

[13] Subsection 118.1(5.2), effective 2016.

[14] See clauses (*c*)(i)(C) and (*c*)(ii)(B) in each of the definitions of "total charitable gifts", "total cultural gifts", and "total ecological gifts" in subsection 118.1(1).

[15] Subsection 248(1) — "graduated rate estate", in force December 31, 2015.

Another benefit is that if the estate is a graduated rate estate at the time the gifted property is transferred and the gift is a gift of publicly traded securities[16] to a qualified donee, an ecological gift, or a cultural gift, the deceased will realize a capital gain of nil on the deemed disposition of the property on death and the estate will realize a capital gain of nil on the actual disposition of the property to the donee.[17]

One drawback to the amendments is that they decrease the flexibility with respect to the allocation of charitable gifts between spouses. In the past, the Canada Revenue Agency's ("CRA's") administrative position was that either the donor or his or her spouse could claim the CDTC. This position has now been codified by amending the definitions of "total charitable gifts", "total cultural gifts", and "total ecological gifts" to include gifts made by the taxpayer's spouse.[18] The administrative position also allowed the spouse of a deceased individual to claim the CDTC with respect to charitable gifts made by his or her spouse under a will.[19] However, none of the amendments will permit the deceased's spouse to claim the CDTC with respect to charitable gifts made by his or her spouse on death. Furthermore, the CRA has confirmed that it will no longer apply this administrative position to gifts made under a will, as the gift will no longer be deemed to have been made by the deceased, but is deemed to have been made by the estate instead.[20] As a result, after the amendments are in force, spouses will have less flexibility with respect to the allocation of charitable gifts between themselves than they did under the CRA's former administrative position.

The amendments with respect to the claiming of the CDTC on death will also likely result in additional administrative hurdles for executors. As set out above, when an individual dies, he or she is deemed to have disposed of all of his or her assets for proceeds of disposition equal to the fair market value of the assets immediately prior to death. As a result, the executors must determine the fair market value of all of the deceased's assets at that time. This can be a relatively simple process for assets such as cash or publicly traded securities. It can be significantly more difficult for shares of a private corporation or real estate assets. Under the current legislation, no further valuations are required when the property is transferred to the donee, because the charitable gift is deemed to have been made by the deceased at the exact same time the deceased is deemed to have disposed of all of his or her assets.[21] However, under the amended legislation, the gift is deemed to have been made by the estate at the time the property is transferred to the donee. If the gift is not a cash gift, the executors will likely have to carry out another valuation of the gifted property at the time the gift is made, which could delay the making of the gift and increase the costs of administering the estate.

Another hurdle executors will have to deal with is the maintenance of the estate's status as a "testamentary trust".[22] This status may be difficult to maintain if trusts outside the will have been used for probate or wills variation planning.[23] If the estate ceases to be a testamentary trust, it will lose its status as a graduated rate estate.

If the estate is not a graduated rate estate at the time the charitable gift is made, then the estate may claim the CDTC only in the year in which the gift was made or in any of its five[24] subsequent taxation years.[25] It will not be able to claim the CDTC with respect to the gift in any of the estate's prior taxation years nor will the deceased be able to claim the CDTC with respect to the gift. Furthermore, even if the charitable gift is a gift of public securities, an ecological gift, or a cultural gift, the deceased will realize any accrued gain on the gifted property.[26] This was not an issue under the current legislation, as the deceased was deemed to have made the charitable gift immediately prior to

[16] That meet the requirements set out in paragraph 38(*a*.1).

[17] Paragraphs 38(*a*.1) and (*a*.2) and subparagraph 39(1)(*a*)(i.1), effective 2016.

[18] See clause (*c*)(i)(A) of each of the definitions of "total charitable gifts", "total cultural gifts", and "total ecological gifts" in subsection 118.1(1), effective 2016.

[19] To the extent the credit was not claimed on the deceased's terminal return.

[20] CRA Technical Interpretation No. 2014-0555511E5, Spousal Sharing of Charitable Gifts.

[21] See CRA *Registered Charities Newsletter* No. 27, Fall 2006.

[22] As defined in subsection 108(1).

[23] For further discussion of this issue, see Pam Prior, "Review of August 29, 2014 Technical Amendments Affecting Testamentary Trusts and Testamentary Charitable Gifting", 2014 British Columbia Tax Conference, (Toronto: Canadian Tax Foundation, 2014), 7B: 1–15.

[24] Ten years, in the case of ecological gifts.

[25] See clause (*c*)(ii)(A) in each of the definitions of "total charitable gifts", "total cultural gifts", and "total ecological gifts" in subsection 118.1(1), effective 2016.

[26] However, any gain on the gifted property between the date of death of the deceased and will be deemed to be nil under paragraphs 38(*a*.1) and (*a*.2) and subparagraph 39(1)(*a*)(i.1).

death, so a delay in transferring the gifted property did not impact whether or not the testator realized a capital gain on death with respect to that property.

The treatment of charitable gifts made by estates that are not graduated rate estates is particularly disconcerting for gifts of all or a portion of the residue of more complex estates, as these estates may take more than 36 months to fully administer and would therefore cease to be graduated rate estates before the gifted property can be transferred to the donee. Similarly, if the estate is the subject of litigation, the executors of the estate may be unable to transfer property that is the subject of a charitable gift within 36 months after the donor's death and the estate may cease to be a graduated rate estate before the gifted property can be transferred.

Individuals can mitigate the risks that their charitable gifts will not be completed within 36 months after their death by making Direct Designation Gifts instead of making their charitable gifts under a will, as the assets comprising the Direct Designation Gifts will not form part of the deceased's estate. Another alternative for individuals who anticipate having a complex estate would be to make specific bequests to qualified donees in their will instead of making a gift of the residue, as the determination of the value of the residue and its distribution to the donee may take more than 36 months to complete. If litigation relating to the estate is anticipated, however, specific bequests may not make a difference with respect to the executors' ability to complete the charitable gift within 36 months after the deceased's death. If litigation is anticipated, individuals could also consider making charitable gifts during their lifetime, as charitable gifts can be carried forward up to five years.[27] However, the individual will lose the ability to use the gifted property[28] for at least 60 months after the gift is made and the value of the CDTC will generally be less with respect to charitable gifts made during the individual's lifetime than with respect to gifts made on death.[29]

We will likely have to wait some time to see whether the amendments with respect to the claiming of the CDTC for charitable gifts made by individuals on their deaths will provide the benefits intended by the Department of Finance. In particular, we will have to wait until at least 2019 to see whether the requirement that the estate be a graduated rate estate at the time the property is transferred to the donee in order to obtain the benefits of the amendments will have a significant impact on donors and their estates. In the meantime, advisers should be cautious when developing charitable donation plans with their clients and should consider both the anticipated complexity of their clients' estates and the likelihood of estate litigation when developing the donation plan. Any plan must also consider the individual's charitable giving objectives.

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RECENT CASES

Transferee liable for tax debts of transferor under section 160

The taxpayer was assessed under section 160 of the *Income Tax Act* (the "Act") as a result of a transfer of real property from her husband to her son, then to the taxpayer herself. The taxpayer argued that she was not properly assessed under subsection 160(2) in the amount of $82,964.55. For this provision, four conditions must be met: (a) a non-arm's length transfer; (b) a transfer of property; (c) the absence of consideration from ultimate recipient; and (d) the transferor must be liable for tax debt in the year the transfer occurred or any preceding year.

[27] Ten years, in the case of ecological gifts.

[28] Subsection 118.1(16).

[29] The definition of "total gifts" in subsection 118.1(1).

The taxpayer's appeal was allowed in part to allow for a minor concession, but was otherwise dismissed. The tax debt flowed through the series of transfers among those non-arm's length parties. The taxpayer failed to demolish the Minister's assumption about the fair market value of the property transfer and consideration given for that transfer, and she did not adduce any evidence that would support her arguments. The Minister did allow for a concession in the fair market value of the property.

¶49,015, *Palmer*, 2015 DTC 1074

Prothonotary acted properly in refusing to dismiss plaintiffs' action — Issues raised to be dealt with at trial

The defendants were appealing an order of the Prothonotary that dismissed its motion to strike the plaintiffs' amended statement of claim and to dismiss the action. The plaintiffs participated in a tax shelter donation program ("GLGI") whereby they claimed charitable donation tax credits that were later disallowed. They made a claim in negligence against the defendants for an alleged breach of duty of care in that the Canada Revenue Agency ("CRA") failed to warn them in a timely fashion of the consequences of participating in GLGI. They were claiming damages for the defendants' failure to warn and protect them. The defendants argued the plaintiffs had no reasonable cause of action. They argued that they had no duty of care and policy considerations dictated against any such duty. The Prothonotary concluded that it was not abundantly clear that the plaintiffs had no chance of success. He based his decision on *Ficek*, 2013 DTC 5104, which supported the proposition that the taxpayers were treated differently than other taxpayers, the provisions of the *Income Tax Act*, the exceptions to the confidentiality provisions, relevant case law (*Anns*, [1978] AC 728, and *Cooper*, 2001 SCC 79), and allegations in the amended statement of claim. The defendants argued the Prothonotary erred by relying on *Ficek* as evidence, by improperly finding that the facts disclosed proximity by interaction, and by failing to conduct the second part of the *Anns/Cooper* test.

The appeal was dismissed. The Prothonotary's order should only be interfered with if it was based on a wrong principle or misapprehension of the facts. In determining whether a duty of care exists that has not previously been recognized, the Prothonotary correctly dealt with recent case law (*Anns* and *Cooper*) that established that a *prima facie* duty of care exists where the facts disclose foreseeability and proximity. One looks at the legislative scheme, which is not determinative here, and at the interactions between the regulator and the plaintiffs. The defendants correctly argued that on a motion to strike, the language of the pleadings is to be looked at in determining whether it is plain and obvious that there is no reasonable cause of action and that no evidence is to be considered. It was not clear if the Prothonotary relied on the *Ficek* case as evidence, but the facts pleaded in the amended statement of claim were sufficient to establish proximity and prevent the claim from being struck. The defendant argued there were no specific interactions between the CRA and the plaintiffs other than the filing of tax returns by the investors and information returns by the tax shelter promoters. However, there was a sufficiently close and direct relationship to justify the argument that a duty of care could be imposed. The plaintiffs argued that the CRA (i) issued the tax shelter number knowing the plaintiffs would rely on it; (ii) allowed GLGI to market knowing they would deny the tax credits claimed; (iii) knew as early as 2000 that there were issues with GLGI; and (iv) waited three years to reassess. While there was no guarantee of success, there was an arguable case that there was enough proximity for a *prima facie* duty of care, and this is an evolving area of the law. The Prothonotary did not deal explicitly with the second part of the *Anns/Cooper* test as to whether there were residual public policy considerations that would negate the imposition of the alleged duty of care. The defendants argued that policy considerations of indeterminate liability negated a duty of care, that whether to issue warnings is a matter of policy, and that warning taxpayers would contravene the confidentiality provisions of the *Income Tax Act*. There would be no floodgate of litigation, it is not so clear that issuing warnings is a policy matter, and there are exceptions to the confidentiality provisions. The legislation did not foreclose the possibility of finding there was a duty of care. The proximity and policy questions were arguable issues that should be determined at trial and there was no reason to interfere with the decision of the Prothonotary.

¶49,022, *Scheuer*, 2015 DTC 5034

Recipient of real property was liable for tax debts of transferor because consideration for transfer was less than fair market value

The taxpayer was assessed under section 160 of the *Income Tax Act* (the "Act") in the amount of $158,058.27 in relation to 1998 to 2001 stemming from amounts owed by the taxpayer's wife. The taxpayer did not challenge the tax debt, the transfer of property, or the non-arm's length relationship between him and his wife. He only challenged the assumption that the consideration paid by him was less than the fair market value of the subject property. There were a number of loans and advances that the taxpayer claimed were consideration for the transfer of the property from his wife's name into his.

The taxpayer's appeal was dismissed. The mortgage debt on the property did not diminish the property's value because the collateral used for that debt was more than sufficient to satisfy all the security registered. In other words, the taxpayer did not assume any debt as consideration for the transfer of the property.

¶49,016, *Loates*, 2015 DTC 1075

Minister's decision to disallow penalty relief to taxpayer was reasonable and within range of possible outcomes

The taxpayer brought an application for judicial review of a decision by the Canada Revenue Agency ("CRA") granting him only partial interest and penalty relief levied on his income tax since 2000. He admitted that he had been non-compliant for many years due to low income levels and the assumption that he did not owe any tax. The taxpayer also suffered an injury in 2012 that limited his ability to work and earn income. The taxpayer later filed his taxes and was assessed an amount for tax plus interest and penalties. He made requests for relief to the CRA, which agreed to waive the $28,000 in interest but not penalties of $10,000.

The application was dismissed. The Minister's decision to deny further relief from interest and penalties was transparent and intelligible, and was within the range of possible outcomes that are defensible in respect of the facts and law.

¶49,019, *Robinson*, 2015 DTC 5031

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