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Maximizing Credits When Gifting by Will and Trusts[1]

By Sandra Enticknap, LLB, Miller Thomson, LLP

Introduction

Many high net worth individuals choose to make significant charitable gifts by Will or by trusts established under their Wills. There are a number of tax rules as well as Canada Revenue Agency (CRA) interpretations that must be considered when structuring a gift on death. As well, it is important for professional advisors to work with their client/donor to determine where the donation tax credit is best utilized, in the terminal return or estate/trust return. The goal is to avoid having the tax liability in one tax return and the donation credit in the other or worse yet, not being able to use the donation tax credit in either return.

This article will review the rules in the Income Tax Act (the "Act") governing gifts on death as well as the CRA interpretations, and discuss planning pitfalls and opportunities.

Credit in the Terminal Tax Return

For many donors, it is important that the donation tax credit be available to be used in the donor´s terminal tax return. To achieve this result, the gift must qualify as a gift by Will under subsection118.1(5) of the Act which provides:

"Where an individual by an individual´s Will makes a gift, the gift is deemed to have been made by the individual immediately before the individual died."

As there is very little case law on what constitutes "a gift by Will," it is necessary to look at the various CRA positions and guidelines. The wording of the Will is critical.

Subsection 118.1(5) will generally be considered to apply where (a) the terms of the Will provide for a donation of a specific property, a specific amount or a percentage of the residue, (b) it is clear from the Will terms that the executors are required to make the gift, (c) the estate is able to complete the gift after payment of debts, and (d) the gift is actually made. Note that subsection 118.1(5) is not elective – if a gift meets the conditions as set out above, it will qualify as a gift by Will and the donation tax credit can only be claimed on the terminal return.

The CRA´s interpretation of what will qualify as a gift by Will is quite strict. It is clear that if the amount of the gift is left to the executor´s discretion, it will not qualify as a gift by Will. However, while the amount cannot be left to the executor´s discretion, the CRA has indicated that:

1. if a defined amount is left to a number of charities but the executor has the discretion to set the allocation; or
2. where a defined amount is left to charity but the executor has the discretion to select the charity; or
3. where a defined amount is left to a private foundation to be established by the executor as instructed in the terms of the Will;

the gift will qualify as a gift by Will (see CRA document no. 2000-0055825 - March 8, 2001, and CRA document no. 0090205 - April 11, 2002).

This does allow for final selection of charities or allocation of a specified amount among them by the executor after the donor´s death.

Other forms of discretion given to an executor could impact on the amount by having an indirect effect. For example, if the executor has discretion to set up a fund for someone in an amount determined by the executor or if the executor has discretion to set up a house fund for the purpose of maintaining residential payments related to a residence trust, that discretion could have an indirect effect on the amount and may impact on whether the gift qualifies as a gift by Will.

It has also been decided that if a Will establishes a testamentary trust and a charity is the remainder beneficiary of the trust, the gift to the charity could still be a gift by Will if the personal representative has no discretion to encroach on capital. In this regard, the case of *O´Brien Estate v. MNR*, 91 DTC 1349 and Interpretation Bulletin IT-226R should be reviewed. The gift by Will is valued by calculating the present value of the residual interests taking into account the fair market value, life expectancy of the life tenant and current interest rates.

Even where a Will establishes a testamentary trust and there are encroachment rights, if it is preferable to have the gift qualify as a gift by Will so the donation receipt can be used in the terminal return, and if there has been no encroachment on capital, it may still be possible to have the life tenant execute an irrevocable disclaimer with respect to capital (see CRA document no. 2002-9117823).

It is also the CRA´s view that where an individual´s Will directs an executor to donate an amount to a charity to bring the amount of income tax liability on the deceased´s final return to zero, the donation will generally qualify as a gift by Will (see Question 15, CRA Roundtable, 2011 STEP Conference).

However, as previously noted, a gift will not be a gift by Will if the executor has discretion as to the amount or discretion as to whether or not to make the gift.

Credit in the Estate/Trust Return

If it is important for the donation tax credit to be claimed in the trust return, only where the trustees are empowered to make gifts at their sole discretion will the trust be entitled to claim the donation tax credit (Interpretation 2004-00621E5). If the trust document simply directs the payment of amounts to a charity, the distribution will be viewed as a distribution to a beneficiary and not as a donation entitling the trust to a donation tax credit. The trustee must have the right to decide whether to make gifts to a charity and in those circumstances, the document should describe the charity as a “gift recipient”, rather than a beneficiary.

Estates with Private Company Shares

One must be very careful in making charitable gifts where the estate holds shares in a private corporation. Where there are corporate shares, there is often planning to avoid double tax, first on the gain realized on death (the deemed disposition) and secondly, when the underlying assets of the corporation are sold and the proceeds distributed. There is often some kind of plan to avoid this double tax, all of which often occurs within the first year after death.

In these circumstances, some of the tax will be in the terminal return but much of it may be in the trust return. If the testator directs in the Will that the estate should go to charity, this gift is a gift by Will. However, the donation tax credit may not be fully utilized in the terminal return and none can be used in the trust return, so much of it could “fall off the table.”

A technical problem can also arise where a private foundation is a beneficiary under a Will where the estate includes corporate shares. Under Section 149.1(1) of the Act, the definition of “non-qualified

investment" includes shares of a corporation that is controlled by the private foundation or persons connected to the private foundation. There is a divestment obligation if the private foundation and relevant persons together hold more than a certain percentage of any class of shares. Under Subsections 188.1(3.3) and (3.5), for the purpose of determining the divestment obligation, if a person, including a private foundation, has an interest in a trust that holds private company shares, that person may be deemed to hold the shares.

Accordingly, even though the private foundation has no control over divestment of the shares and may not even be a beneficiary of the shares at the end of the day, the private foundation may still have a divestment obligation related to shares which it does not control or have any entitlement to.

As can be seen from the above discussion, it is extremely important to keep these various tax rules and CRA interpretations in mind when drafting Wills and trusts that include charitable bequests.

About the Author

Sandra Enticknap, LLB, is a Partner with Miller Thomson LLP, in Vancouver, BC. She practices in the area of estate and incapacity planning, estate litigation, charitable gift planning, and related matters. Sandra can be reached at 604-643-1292.

Endnote

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