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PUBLICATION

Wills Must Be Planned and Managed Carefully for Full Tax Benefit of New Charitable Gift Rules

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We have all heard the saying “nothing is certain but death and taxes”. While the certainty of death and taxation remains unaltered, the Department of Finance of the Government of Canada is attempting to deal with the complexity that exists where the two concepts intersect.

There is already quite a bit of (perhaps) unnecessary complication in the current rules governing the treatment of tax credits that arise when charitable gifts are made upon death. Changes to these rules were enacted in 2014. The new rules, which come into force only for deaths occurring after December 31, 2015, reduce some of this complexity but may require adjustments to your current planning if you are to realize the full tax benefit.

Under current (pre-amendment) rules, people must be very careful in their estate planning to ensure that any charitable gifts that are to be made upon their deaths get the appropriate income tax treatment. Often there will be income taxes payable upon a person’s death. These income taxes can be reduced if charitable tax credits are available. Normally a gift to a charity gives the donor a tax credit that can be used to reduce income tax. However, for income tax purposes, a “person” (i.e. a living human being) is a taxpayer who is separate and distinct from the “estate” that arises upon his or her death. Hence, if an “estate” donates property to charity, the donation credit cannot be used to reduce the taxes owing of the person who has just died.

The current rules solve this problem through a mechanism that is quite restrictive. The *Income Tax Act* provides that if a person’s last will and testament mandates that a gift is to be made out of the person’s estate, the tax credit arising from that gift is deemed to have been made by the deceased person (rather than the estate). This has the effect of allowing the charitable tax credit to offset the tax arising upon the person’s death. In fact, if a surplus tax credit remains (because the tax credit is greater than what is necessary to eliminate taxes in the year of death), it can be carried back to the person’s tax return in the year prior to his or her death. Conversely,

the tax credit that arises under this structure cannot be used to offset any tax in the “estate”. This is an unfair result because a gift made while a person is alive allows the tax credit to be used over five future tax years, rather than only two.

The new rules give much greater flexibility. They no longer deem all charitable gifts to have been made by the deceased immediately prior to his or her death. Instead, beginning next Jan. 1, all charitable gifts made by the deceased on his or her death will be deemed to have been made by his or her estate at the time the property is transferred to the charity. However, the executors of the estate are then allowed to allocate the resulting tax credit amongst the following different tax years:

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

(2) the previous taxation years of the estate, and

(3) the taxation year of the estate in which the property is transferred to the charity.

So, for example, let’s assume Mr. Smith dies on December 31, 2016 and his will provides that his executors are to donate $50,000 to the Canadian Cancer Society. Further assume that his executors do not make the donation until 2019 because it takes a while to sell the deceased’s business and raise the cash necessary for the gift. The executors will be able to apply the tax credit against the income arising in Mr. Smith’s 2015 and 2016 tax years and the estate’s tax years of 2017, 2018 and 2019.

There are certain conditions that must be satisfied in order for these new rules to apply.

First, the estate must qualify as a “graduated rate estate”. This is a new term that has a particular definition under the *Income Tax Act.* While most estates will likely qualify, careful planning is necessary to ensure that is the case.

Second, the charitable gift must be made within 36 months of the deceased person’s death. Hence, if the executors fail to make the gift within that time, the benefit of these new rules is lost. This can be a problem if the estate is particularly complicated or if the estate is the subject of litigation. In such cases, 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 new tax rules will be inapplicable.

As noted above, under the new rules, the gift is deemed to have been made by the estate at the time the property is transferred to the charity. This results in a particular anomaly that might affect certain estates. While the tax credit from the gift can be applied flexibly against several years of income as described above, problems may arise if the gift is not a cash gift. If a person is donating specific property (such as shares of a company or a parcel of real estate), the executors will likely have to carry out two separate valuations of the property: one valuation at the time of death to determine the taxes payable by the deceased, and another valuation at the time the gift is made in order to determine the value of the tax credit.

Two valuations at different times impose two costs on the estate. In addition, if the second, later valuation is lower than the first one and thus provides for a relatively smaller tax credit, the intended estate plan may be upset. Beneficiaries may not get what the deceased person intended for them.

It is worth noting that in addition to the new rules described above, further changes to the charitable gift rules applicable upon death were proposed in the 2015 federal budget. If these rules were to reappear after the October 19, 2015 federal election and were subsequently enacted, they would provide additional tax benefits where an estate donated the proceeds resulting from the sale of private company shares or real estate.

So while the new charitable giving rules provide a degree of flexibility lacking under the current rules, care must be taken both in the planning and administration of an estate to ensure that the estate will actually be able to take advantage of them.