New Charitable Donation Rules are Coming – Are you Ready?

By Margaret O'Sullivan

Various changes to the Canadian tax treatment of charitable gifts are on the horizon and are set to become law over the next few years. In 2016, changes to the rules dealing with estate donations will for the most part provide greater flexibility in claiming donation tax credits. And if enacted, recently proposed changes to eliminate capital gains on donations of private corporation shares and real estate will become law in 2017. These changes are generally beneficial to taxpayers as they enhance both flexibility and associated tax benefits in making donations.

ESTATE DONATION RULES

Benefits of Donation Tax Credits on Death

On death, Canadian income tax law treats a deceased person as having sold all of his or her capital property for fair market value, resulting in tax on any capital gains. Capital property typically includes real estate, non-registered investments, and artwork. The full value of any RRSPs or RRIFs owned on death is also included in income. These rules usually result in a significant amount of tax owing on death. The example below illustrates the tax benefits associated with making a charitable gift on death:

Bob lives in Ontario and has no spouse. He owns an art collection that has appreciated in value by $400,000 and a RRSP wort h $250,000. On Bob's death, his estate will owe approximately $195,000 of tax. If Bob were to include a $250,000 charitable gift under his will, his estate would be entitled to a donation tax credit of approximately $100,000, which would decrease the tax owing on Bob's death, including Ontario surtax, to approximately $80,000. In effect, the net cost of the donation to Bob would be approximately $135,000, given the tax savings.

The donation tax credit is calculated by multiplying the amount of the donation by the highest federal tax rate (29%) and, in the case of Ontario, by Ontario's highest tax rate in 2011 (11.16%) for a total rate of 40.16%. Ontario's highest tax rate in 2011 is used, as opposed to its highest tax rate for 2015, because such is required by the relevant legislation. The total of those two amounts is the amount of the donation tax credit. In the above example, the donation tax credit would be calculated as follows: $250,000 x 40.16% = $100,400 (which was rounded to $100,000 for the purposes of the example). In addition, the donation would also decrease any Ontario surtax owing on death. As set out below, however, there are certain limitations on the amount of a donation that can be claimed in a particular year.

If Bob had a surviving spouse or common-law partner, tax liabilities on his death could likely have been deferred until the death of Bob's spouse unless capital property was sold earlier.

Current Estate Donation Rules

Currently, an estate is entitled to a donation tax credit for any gift made by will or by beneficiary designation, such as where a charity is designated as the beneficiary of a RRSP, RRIF, TFSA or life insurance policy. The credits can be applied against taxes owing in the year of death or the prior year up to 100% of the deceased's income in each of those years (the credit is limited to 75% in any other tax year). It is not possible to apply the credits against income earned after death.

Sometimes a gift made by will does not qualify for the above tax treatment. Where this is the case, the estate will only be entitled to a donation tax credit in the year the gift is made and any of the five following years.

This usually produces a bad result: estates often have little or no income after the deceased's death to apply the credits against (unlike in the year of death). A gift may not qualify if, for example, the executors have discretion to determine how much is to be given to charity or whether the gift is to be made at all.

One of the favourable benefits of the current rules is the sharing of donation tax credits by spouses and common-law partners ("spouses") – credits may be claimed by the deceased spouse's estate or by the surviving spouse. This sharing is often useful where the deceased has little or no tax owing in the year of death, such as where the deceased's estate qualifies for the tax-free transfer of property to a surviving spouse and taxes are deferred as a result.

New Estate Donation Rules

Under the new rules which apply to deaths after 2015, in addition to being able to apply donation tax credits against taxes owing in the year of death and the prior year, the credits can also be used by the estate in the year the gift is made to the charity and any prior year of the estate (up to a maximum of 75% of the estate's income in each of those years). These rules only apply to donations made by a "graduated rate estate" (GRE).

A GRE is new to Canadian tax law and means:

a) an estate that arose as a consequence of an individual's death;

b) no more than 36 months have passed since the date of death;

c) the estate is considered a testamentary trust for tax purposes;

d) the estate designates itself as a GRE;

e) no other estate (relating to the deceased) designates itself as a GRE; and

f) the deceased's social insurance number is provided in the estate's tax return.

The executors or other legal personal representatives (the "executors") on death must make the donation to the charity within 36 months after death in order to obtain the benefit of the new rules (since an estate does not qualify as a GRE after such time). Overall, the new rules offer more flexibility to allocate charitable tax credits within a five-year time frame of two years prior to death and three years after death.

If the executors fail or are unable to make the gift within 36 months after death, the estate will only be able to claim the credit in the year the gift is made or in any of the five following years. As noted earlier, this may produce a bad result since the estate may have little or no tax in those years to apply the credit against.

In some cases, it will simply be impossible for the executors to make the gift within 36 months – for example, where the estate is tied-up in litigation or where the estate assets are illiquid. Where these types of obstacles are a concern, pending possible changes to the rules to address this issue, such as a process to provide for an automatic extension or eliminating the requirement that the gift must be made by a GRE, it may be preferable to designate the charity as the beneficiary (or one of the beneficiaries) of a registered retirement plan or life insurance policy as such proceeds pass outside of the estate and are generally paid out or transferred fairly quickly after death, or to consider other planning options.

The new rules also feature some unfavourable changes. There is an existing exemption from tax on gifts of publicly listed securities, ecological gifts and cultural property that will only be available to gifts made by a GRE after 2015. The sharing of donation tax credits between a deceased's estate and surviving spouse will also disappear—leading to a possible loss of credits if the estate owes little or no tax, as well as less flexibility in allocating charitable gifts between spouses.

The following example demonstrates how the new rules will work (some of the figures are approximated):

Laura died on December 31, 2016 in Ontario and was married at the time of her death. Her net income in 2016 was $300,000. The net income of her estate in 2017 was $100,000. Laura provided a charitable legacy of $400,000 under her will, which was paid to the charity in 2018. In total, Laura and her estate are entitled to a donation tax credit of $160,640 (i.e., $400,000 x 40.16%). To eliminate the taxes owing in 2016 (i.e., $114,000), Laura's executors under her will elect to apply $285,000 of the donation against her income in 2016. To eliminate the taxes owing in 2017 (i.e., $25,000), Laura's estate trustees elect to apply $63,000 of the donation against her estate's income in that year (only $63,000 of the donation is used in that year because that is all that is required to reduce taxes owing to nil). Unless Laura also had income in 2015 that the credit could be applied against, Laura and her estate would not be able to use the remaining $52,000 of the donation and it would effectively be lost as her spouse is also unable to claim her unused donation. In effect, the net cost of the donation to Laura would be $261,000 (but would be even less if Laura or her estate had additional income).

While Laura and her estate are entitled to the total donation tax credit of $160,640 noted above, she and her estate did not have sufficient income to utilize the full credit.

One drawback of the new rules is that if certain types of property are donated they may require additional valuations. For instance, if real estate is donated, it will often be necessary to determine its value at the time of death (for the purpose of the deemed sale on death tax rule outlined above) and also at the time of its transfer to the charity. Under the current rules, it is generally only necessary to determine the value at the time of death because those rules treat the donation as having been made immediately before death (the same time used for the deemed sale rule). The new rules, however, consider the donation to have been made when the property is actually transferred to the charity—typically being a date sometime after death. In order to avoid having a second valuation done at the time the property is transferred to the charity, which can be expensive depending on the nature of the property, in certain cases the preferred option may be to donate cash instead.

Proposed Capital Gains Exemption Rules for Gifts of Private Corporation Shares and Real Estate

The 2015 federal budget contained a welcome proposal to eliminate capital gains tax on donations of cash proceeds from the sale of private corporation shares and real estate. This exemption will be available where cash proceeds from the sale of shares of a private corporation or real estate are donated to a charity within 30 days of their sale to a third-party who is unrelated to the seller and the charity. The exempt portion of the capital gain will be determined by reference to the proportion of the cash proceeds that are donated (in case the donor does not wish to donate the entire sale proceeds).

These new proposals will in particular assist donors who have liquidity events and wish to make a gift at the time of a sale. Prospective donors should consider seeking tax and legal advice at this time well in advance of any sale of shares and real estate to plan their donation in the most tax-effective manner.

In respect of donations by will, the proposed changes apply if the shares or real estate is deemed to have been disposed of on death (meaning that the shares or real estate must not pass to the deceased's spouse on death on a tax-deferred basis), a GRE subsequently sells the shares or real estate to a third-party, and the GRE makes an eligible donation within 30 days of the sale, among other conditions. If the shares or real estate passes to the deceased's spouse on a tax-deferred basis, the spouse will be able to claim the exemption in accordance with the new rules discussed further above.

Based on draft legislation released on July 31, 2015, the proposed changes are to become law in 2017 if enacted.

Charitable Outlook

Canada's charitable donation rules have seen many recent changes. Most of these changes are beneficial to taxpayers, providing more options to structure donations to minimize tax.

It is important to seek advice from your professional advisors to address your individual circumstances when arranging any new estate donation. You may also wish to review existing estate donation plans to ensure that they will continue to meet your desired goals and objectives.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. The information is current to August 31, 2015. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. Readers are cautioned to consult their own professional advisors to determine the applicability of information and opinions in this newsletter in any particular circumstances. This article is copyright; its reproduction in whole or in part by any means without the written permission of the copyright owner is forbidden.

Margaret O'Sullivan is principal of O'Sullivan Estate Lawyers, a Toronto trusts and estates boutique law firm. Her practice involves all aspects of private client work, including estate planning; will and trust planning; incapacity planning; estate litigation; advising executors, trustees and beneficiaries and administration of estates and trusts. Recipient of the 2014 Society of Trusts and Estates Practitioners Founder's Award for Outstanding Achievement and the Ontario Bar Association's 2013 Award of Excellence in Trusts and Estates Law. Frequent speaker and writer on trust and estate matters.