Current Issues in Charitable Tax Planning*

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Gifts of Private Company Securities – Residue from Resolution 21

In 1997 the federal government introduced sweeping anti-abuse rules (Resolution 21 of the Budget), which were said to be necessary in order to stop the use of so-called loanback transactions in the charitable sector. The sector objected loudly and with what was a remarkably united voice so that in the end those officials at the Department of Finance who were the initiators of this legislation made a partial retreat. But in the end we have been left with a complex residual overlay of rules that, more than anything else, have choked off the flow of gifts of private company securities to charity. These are the same rules that began the persistent discrimination against private foundations that has been pursued further by the legislators in subsequent budgets.

What has made these rules particularly hard to accept is the sharp contrast between the harsh treatment they impose on private company securities (and private foundations) on the one hand and the generous incentives we have seen from the same legislators in relation to other categories of property on the other hand.

Non-Qualifying Securities

The full weight of the restrictions introduced in the anti-abuse rules from 1997 is directed at securities issued by private companies but the legislative language does not refer anywhere to "private companies". Instead, the legislation introduces the concept of a "non-qualifying security". A gift of a non-qualifying security attracts the wrath of the legislators; it is treated as a nonevent unless the gift is "monetized" by the charity within five years. The definition of a non-qualifying security is to be found in subsection 118.1(18) of the *Income Tax Act* and must be studied carefully to discern the scope of the remaining restriction on gifts of securities issued by a private company.

Definition

The definition is divided into three parts to deal separately with the only three categories of property covered: "obligations", "shares" and "any other securities"; the latter category being comprised of securities that cannot fairly be described as an obligation or a share. It is a snapshot definition; meaning that

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it is to be applied to an individual (see subsection 110.1(6) for the corresponding provision applicable to corporations) at a particular point in time to determine if the security under consideration is a non-qualifying security of that individual.

The definition could perhaps be described as a "*double* snapshot" because the key element of the definition requires that a second snapshot be taken immediately after the particular time to see if the individual and the issuer of the security are then at arm's length or not. (Remember that in the arcane world of tax law an individual is presumed not to be at arm's length with himself for purposes of rules such as this.) If the individual and the issuer are not at arm's length in the second snapshot the security will be a non-qualifying security of the individual and dealt with unfavourably as an undesirable gift. If the individual and the issuer are at arm's length in the second snapshot then the definition does not apply and the gift of the security is treated normally.

The first pair of snapshots will be taken at the time of the gift and immediately after the gift is made. Because the rules for non-qualifying securities (subsection 118.1(15) of the *Act*) contemplate a point in time subsequent to the gift and within 60 months of the gift when the security may cease to be a non-qualifying security, it will be necessary to monitor the non-arm's-length relationship between the individual and the issuer for 60 months. If the individual and the issuer become at arm's length at a point in time within that period the double snapshot will confirm that the security has ceased to be a non-qualifying security as soon as that happens.

In other words, the application of the onerous non-qualifying-security rules has nothing to do with whether the security under consideration was issued by a private company but rather focuses on whether the individual is not at arm's length with the issuer of the security. Whether the gift will be trapped under the anti-avoidance rule will be determined by whether the donor/individual was non-arm's length from the issuer of the gifted security immediately after the gift was made or became arm's length at any subsequent point in time within 60 months after the gift was made. Arm's length is the important issue.

Arm's Length or Not

In the case of a private company the question of whether or not an individual might be at arm's length from the company is the subject of some very convoluted tax rules. It is clear that the individual will not be at arm's length from the company where the company is controlled by:

- the individual
- a person related to the individual
- a related group of which at least one person is related to the individual
- a trust in which the individual is beneficially interested.

The definition of non-qualifying security contemplates the death of the individual and accordingly, with respect to a situation where the individual has ceased to be at non-arm's length because of death, it will be necessary to take the snapshot over again with the estate taking the place of the donor/individual to determine if the estate is or is not at arm's length with the issuer of the security. As with the individual, it will be clear that the estate will not be at arm's length with the company where the company is controlled by:

- the estate
- a person or persons beneficially interested in the estate (and therefore not at arm's length with the estate), or
- a person or persons not at arm's length with a person beneficially interested in the estate.

In addition there is always the possibility that an individual might not have a control relationship with the company but might nonetheless exert such actual influence over the company as not to be at arm's length.

Gifts of Private Company Securities Not Affected by the Rules

These rules are difficult to follow and extend the non-qualifying property rules so that they apply in most situations where a company is controlled by a related group of persons, such as a family owned company. However, as with all mechanical rules, there are gaps and there may be a surprising amount of scope left for individuals' gifts of securities issued by private corporations. For example, the following gifts should remain outside the scope of the definition of non-qualifying security and therefore be treated normally:

1) a gift of either shares or debt by a minority shareholder who is not related to the other shareholders of the company;
2) a gift of all of the shares of a company (except to an incorporated foundation controlled by the individual or persons related to the individual);
3) a testamentary gift of either shares or debt (except where the estate has not yet been wound up and the securities are issued by a company that, after the gift is made, is controlled by the estate, a person or persons beneficially interested in the estate or by a person or persons related to such persons).

Gifts of Private Company Securities That Come Under the Rules

With only two exceptions, a gift of a private company security that comes within the definition of a non-qualifying security will be treated as a *postponed* gift (see subsection 118.1(13) of the *Act*). The exceptions will be first, a gift that meets the definition of an "expected gift" (see subsection 118.1(19) of the

Act) and second, a gift that falls into loanback provisions (see subsection 118.1(16) of the *Act*).

A gift of a non-qualifying security is treated as a nonevent for tax purposes. The real change in property ownership that occurs at the time the donor transfers the property to the charity is not recognized either for purposes of tax credits or for purposes of tax on the disposition. In the words of the legislation "the gift is deemed not to have been made".

Recognition of the transaction is postponed if, during the first 60 months after the gift, the property ceases to be a non-qualified security or, alternatively, the donee monetizes the gift in which case recognition for tax purposes will occur at that time. If neither event occurs within the 60-month period, recognition will never occur. If recognition does not occur that means that the donor will never receive tax credits for the gift but it also means that the donor will never face the tax normally associated with disposition of the property. A determined donor might make the transfer and forego the tax credits reasoning that avoiding the tax on disposition makes it worthwhile but, for a tax-conscious donor, there is more lost than gained. The tax credits are based on 100 per cent of the value of the property while the tax payable is based on only 50 per cent of the value of the property, so the effect of the rules will be to deter the donor from making such a gift in most circumstances.

We have already seen that if the non-arm's-length connection is broken between the donor and the issuer of the security within the first 60 months, the property will cease to be a non-qualifying security and recognition will occur at that time. Similarly, if the donee charity monetizes the security within the 60-month period, recognition will be triggered at the same time as monetization.

The word "monetization" does not appear in the legislation. Instead, the provisions of paragraph 118.1(13)(c) of the *Act* refer to a disposition by the donee (to any person) and specify that the consideration received by the donee on the disposition (to the extent that it is not itself a non-qualifying security of the donor), will be the fair market value of the gift at that time.

Recognition means that the reserve allowed to the donor on the original postponed gift is brought back into income in the year and it means that the donor will be allowed tax credits in the year based on the lesser of the fair market value at the time of the original transfer and the fair market value at the time of recognition. (Note that the donor will not receive any benefit from any growth in value of the property over the interval but will be penalized for any erosion in value over that interval.)

Excepted Gifts

The concept of an excepted gift was carved out within the category of non-qualifying securities as a last minute addition to the anti-avoidance rules. To qualify, the security must be a share, the donee must not be a private foundation

and the donor must be at arm's length from the donee and all of the donee's functional officers. If the security meets the definition, it is saved from non-qualifying-security status (although it remains a non-qualifying property) and is dealt with as a normal gift. In those circumstances where the donor or a person related to the donor holds an office in the charity to which the gift is being made it will be necessary for the donor or the related person to resign the office before the gift is made.

Loanbacks

The loanback rule (in subsection 118.1(16) of the *Act*) is designed to apply where a combination of events has occurred. One of the events that must have occurred is the receipt by the charity of a conventional gift, i.e., a gift that is not a non-qualifying property. This could be a gift of cash, real estate or other property. If the property falls within the category of a non-qualifying security it must be an excepted gift to satisfy this first element of the combination.

The second element in the combination is the acquisition by the donee of a non-qualifying security of the donor. If the second element of the combination is satisfied within a time period looking back 60 months and forward 60 months from satisfaction of the first element of the combination the combination will be treated as a loanback.

In the real world a loanback was most often a gift of cash to a charity followed by a loan at market terms back to the donor of all or substantially all of the cash. Obviously the statutory language is much wider and sweeps into the rule, combinations of transactions that may be connected or completely unconnected. Any time a donee is to acquire a non-qualifying security from a donor it must review its history with the donor and monitor its future with the donor to ensure that no conventional gifts are received from the same donor within the 120-month time frame because the loanback rule requires that the fair market value of such a gift (the basis for determining the related tax credits) be reduced by the fair market value of the consideration given by the donee to acquire the non-qualifying property. Real-world loanbacks can still occur provided there is an interval of more than 60 months between the two elements of the transaction.

Testamentary Gifts – Anomalies and Mismatched Results

Very few testamentary gifts will navigate unscathed through the possible hazards awaiting even the simplest of testamentary gifts to charity. It should be simple to leave something to charity in your will. The fact that it is not simple is a concern shared by everyone – donors, charities, advisors and legislators. We can draw comfort from the expectancy that help may be on the way and walk carefully in the meantime.

The problems plaguing testamentary gifts stem from two sources. First, the relevant tax law itself appears to have inherent conflicts. Second, the interpretations of the Canada Customs and Revenue Agency (CCRA) have not always

been well founded or consistent. In fairness, some of the positions taken by the CCRA may represent attempts to be helpful in bridging some of the gaps in the law. However, the overall result is destined to confuse and deter would-be testamentary donors by frustrating and complicating a wide range of straightforward testamentary gifts.

This article will discuss four problems. The first and most dangerous problem is the potential mismatch that can arise where the estate tax plan and the charitable gift plan are not co-ordinated, with the result that, as between the two taxpayers, the individual (terminal return) and the estate, the incidence of tax arises with one taxpayer and the charitable tax credits with the other. The second is a more practical problem which arises simply because of the time it often takes to administer the estate to the point where the charitable gift can be delivered. The third is an apparent conflict in the tax law affecting all trusts making a charitable distribution. Finally, it will touch on a related and difficult problem affecting spousal trusts under which there is a gift over to charity.

Mismatch of Tax Liability and Tax Credits; A Gift by Will or Not

Typically, a relatively large amount of tax becomes payable on an individual's death. Accordingly there is often a great deal of planning devoted to the question of whether the tax may be best dealt with as a capital gain in the individual's terminal return or as a (deemed) dividend in the individual's estate. Over the past decade or more it has become very popular to adopt the dividend strategy, which shifts the death-related tax out of the terminal return and into the estate. Although the recent reductions in the capital gains inclusion rate will make the dividend strategy less popular, there will probably be a larger number of estates that will continue to adopt the dividend strategy for the foreseeable future. These will tend to be estates in which a large proportion of the asset value is represented by shares in private companies such as investment holding companies or operating companies.

Mismatch

Two factors heighten the importance of ensuring that both the tax liability and the charitable tax credits accrue to the same taxpayer (the individual terminal return or the estate). First, as already mentioned, the amount of tax payable arising in the event of an individual's death is likely to be relatively large. The deemed disposition rules triggered at death normally force the individual to account for a lifetime of accrued untaxed gains. Second, the limitations restricting the extent to which charitable tax credits may be claimed in a year were amended following the 1997 Budget to allow the taxpayer to use the credits to offset 100 per cent of the tax otherwise payable in the year of death. So the stakes are high.

Gift by Will or Not

The determining factor that establishes whether the tax credits will be available to the individual's terminal return or to the estate will be the CCRA's interpretation of whether the gift is a gift by will or not.

To make this determination, the CCRA compares the language in the taxpayer's will with what the agency has established as the legislative requirements for a gift by will. The legislative requirements are based on the CCRA's interpretation of subsection 118.1(5) of the *Act*, a provision which deems the gift to have been made immediately before the individual died where the gift is made "by the individual's will". This timing rule is absolutely necessary in order to align the timing of the gift with the timing of the tax liability under the deemed disposition rules triggered by death.

Problems arise because the interpretations placed upon this provision by the CCRA are probably not supported in law and are not always consistent. The CCRA might be forgiven for seeking to find, within the rule in 118.1(5), a rationale for distinguishing between cases where a gift might be attributable to the terminal return and cases where the gift might be attributable to the estate. Supplying the needed rationale might very well be an effort to help taxpayers who might otherwise find it very difficult indeed to arrange to have a testamentary gift made from the estate for tax purposes.

The CCRA's distinction between a gift by will and a gift not by will seems to be a somewhat amorphous concept of independent decision-making by the trustees administering the estate. If enough scope is left open for trustee decisions on the selection of the charity or the quantum of the gift, the CCRA will tend to treat the gift as "not a gift by will" and, instead, as a gift by the estate.

Advisors will be obliged to review the now relatively large number of written interpretations issued by the CCRA on this issue. In arriving at their conclusions as to the appropriate testamentary structure and language for the proposed gift an advisor might be tempted to add yet another request for an interpretation from the CCRA based on the particular circumstances of the advisor's case.

Proposed Remedy

This highly unsatisfactory state of affairs has led the Canadian Association of Gift Planners (CAGP) and others to propose a remedy in the form of an "executor's election". The general nature of such a device would be to place the executor of every will in which there is a charitable gift contemplated in the position of choosing, by way of an election to be filed within a stipulated period, to apply the tax credits from the gift in the year before death, in the terminal return or in the estate or in a combination of these. This proposal appears to have the merit of no identifiable downside and no visible opponents. But it needs to be identified as a priority for action to be taken.

Estate Administration; Hiatus Between Death and Delivery of the Gift

It is not unusual that an executor might work for a number of years on an estate before the administration is brought to a stage where a testamentary gift to charity can actually be delivered. What is an executor to do about the gift in the meantime?

Advice to the executor would be based in part upon the nature of the gift. Even if the gift is simple – a gift of a share of the residue of the estate, for example the executor may be forced to adopt a concocted solution. One strategy in such a situation might be to file a terminal return that reflects a gift based on an estimate of the amount of the gift so as to preserve all of the taxpayer's options with respect to the gift. At the subsequent point in time when the amount of the gift is ascertained and delivered and a receipt issued, the earlier return could be amended to accurately reflect the gift.

Trust Distribution or Gift

For all trusts under which there is a charitable beneficiary there is an unnerving conflict between the rules governing distributions from a trust and the concept of a charitable gift. This problem is compounded by the theoretical vulnerability associated with every gift made using a trust vehicle, i.e., that the time of the gift may indeed be at the time the trust is constituted and must be claimed at that time, not at the subsequent point in time when the trust actually delivers the gifted property.

Equitable Interest in a Trust

When an asset is transferred to a trust and there is a charitable beneficiary under the trust there is a strong argument that at that early stage the charitable gift has occurred. The charitable beneficiary acquires an equitable interest in the trust at its inception. Where there are intervening rights under the trust (particularly any right to encroach on capital) the nature and value of the right of the charitable beneficiary may be difficult to ascertain but the right came into existence despite such difficulties.

In some circumstances where the gift is ascertainable, the associated tax credits might be claimed at the outset. Where "ascertainment" is difficult, claiming the tax credits at the outset is not possible.

The question is whether the failure to claim the tax credits at the outset, whether inadvertent or consequential, should stop the taxpayer (or the trustee) from claiming credit for the gift when it is later ascertained and actually delivered from the trust to the charity. It is to be hoped the public policy answer to this question is "no". Not all scenarios giving rise to this problem are complex. As already illustrated, simple donation arrangements are as likely to be trapped in this difficulty as are complex arrangements.

Distributions from a Trust

When, at a point in time, the trustee of a trust, whether testamentary or *inter vivos*, delivers the property held for the benefit of the charitable beneficiary, the transfer of the property from the trust to the beneficiary will almost certainly qualify as a distribution in satisfaction of a capital interest as contemplated by subsection 107(2) of the *Act*. The question arises whether in such circumstances subsection 118.1(3) of the *Act* remains applicable and which provision would govern. It appears that, if this issue is left to the CCRA to interpret, a somewhat fuzzy intention test will be applied (see document #991821 dated December 1, 1999, and document #9304745 dated March 23, 1993). CCRA will look at the facts and decide if the real intention was gift (subsection 118.1(3)) or capital distribution (subsection 107(2)) and charitable tax credits will be allowed or denied based on the outcome of the test.

Proposed Remedy

The treatment of a distribution from a trust to a charity should not turn on such distinctions. The proposed remedy is the adoption of a rule much like the recent deeming rules applied to direct designation of charities as beneficiaries of life insurance policies and retirement plans. A distribution from a trust to a charity would be deemed to qualify as a charitable gift except in circumstances where the credit for the gift was claimed earlier (e.g., at the time the trust was established).

Spouse Trust with Residual Charitable Gift

It is not uncommon for a taxpayer to establish a testamentary spouse trust to make sure that the spouse is adequately provided for with a gift over to charity on the death of the spouse. The trust may or may not give the trustee the power to encroach on capital for the benefit of the spouse. The taxpayer has a clear charitable intent but it is secondary to providing for the spouse.

Usual Trust Issues

Despite a clear charitable intent, the taxpayer's gift may be denied the tax credits for all of the reasons identified above. On the transfer to the charity the trust may be looked upon as simply complying with the legal obligations imposed by the terms of the trust and denied the tax credits. Alternatively, where there was a power to encroach in favour of the spouse, a charitable gift may be found in the trustee's forbearance to encroach.

No Carryback

In addition to all the difficulties associated with a gift through a trust, a spouse trust may find itself in even more difficult circumstances where the spouse dies close to the end of the year. Unless the gift is made in the year the spouse dies the tax credits (if any) are likely to be isolated in a subsequent year when there is no prospect of income and no provision for a carryback to the trust's previous taxation year.

Alter Ego and Joint Spousal Trusts

These new categories of trust, recently introduced in a proposed amendment, suffer from the same difficulties, including the lack of a carryback when income is triggered for the trust on the death of a beneficiary.

Proposed Solutions

In addition to the remedies for trusts already referred to above it would be reasonable to introduce a carryback provision for spouse trust, alter ego trusts and joint spousal trusts.

Funding Private Foundations; Ending the Trend of Discrimination

Tangible Discrimination

Private foundations do not have access to excepted gifts (private company shares) or to gifts of publicly listed securities that qualify for the reduced-income inclusion for the donor (including shares arising from options). These biases against private foundations are highly prejudicial and must be addressed urgently if private foundations are to remain a vigorous part of the Canadian charitable sector. Strong private foundations are necessary to provide a balance of prudence and creativity across the sector.

Fears of Abuse

The fear on the part of the legislators appears to be the potential for self-dealing abuse more potentially available where donors are dealing with their own foundations. Whether such fears are justified is moot. Whether it is more damaging to assume the worst and infer guilt before conviction or to assume the best and leave open the possibility of a scandalous abuse that would impeach the sector generally would be a great debate for a committee somewhere.

What has not been forthcoming thus far is a serious proposal from the charitable sector that takes the prospect of abuse into account and proposes legislative safeguards. The task of producing such a proposal or series of proposals lies ahead.

Proposed Step to Reduce Discrimination

In the meantime it would be productive to examine areas in which the discrimination against private foundations could be reversed without at the same time introducing any significant risk of abuse. There may be other possibilities but at least one such proposal can be tendered for consideration at this point.

The CAGP has proposed a revision to the existing law that would extend, to private foundations, access to gifts of publicly listed securities (including securities arising from options) to which the reduced-income inclusion incentive would apply, provided that the foundation monetizes the gifted securities within a reasonable specified time period. Gifts of this nature have proven to be immensely attractive to public charities since they were introduced several

years ago. Allowing such gifts to be made to private foundations would stimulate a recovery in private foundation funding. Forcing the foundation to sell the securities within a reasonable time frame would convert the gift to cash and end any prospect of continuing virtual ownership by the donor.

If the government were prepared to move on a proposal such as this, it would provide a welcome signal to the charitable sector and its donors that the private foundations has a viable future in Canada.