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COMMENT

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How Planned Giving Strategies Fit In with Estate Planning

by Joël Campagna

As we enter 2022, we have just come through prime charitable giving season. Often, at year end individuals review their donations for the year and consider making additional gifts so that the tax benefits are recognized in the current year. A donation made in December of 2021 reduces taxes owing for 2021, and the cash flow benefit of the donation is received by April 30, 2022 (or earlier for those who file their tax returns before the deadline). Since charitable donations are fresh in many people's minds, this can be a great time to speak with your business-owner clients about reviewing their will and estate planning and ensuring that any charitable gifting done in their will is properly structured.

At death a significant tax bill can arise if the individual does not have a spouse to roll their assets and registered plans to. An individual is deemed to dispose of all of their capital property (e.g., shares of private companies, real estate, public company securities) at fair market value immediately before death and thus recognize capital gains. Furthermore, the value of assets held in registered plans such as RRSPs and RRIFs will also be included in income in the year of death. This can result in a significant tax bill.

One way to mitigate this tax bill at death is to have the person's will provide for gifts to charity and claim a donation tax credit in their terminal tax return. The claiming of the donation credit is contingent on several things, including the timing of the donation, the designation of the estate as the graduated rate estate (GRE), and the type of property donated, with special rules governing gifts of a non-qualifying security, discussed in more detail below.

When an estate is a considered the GRE it has the benefit of being taxed at graduated rates for up to 36 months. Another tax benefit that hinges on GRE status is the ability to flexibly use charitable donation credits.

Where a charitable gift is made within 60 months of death and it is made by will, the estate, or by direct designation, if the estate qualifies, or previously qualified as the GRE, there is greater flexibility in claiming the charitable donation tax credits. That is, the charitable donation tax credit can be claimed:

- in the year of the gift by the estate against 75% of net income with a carry forward of five or 10 years (depending on the type of property that is given);
- carried back to the deceased's final (terminal) return for the year of death or the year prior to offset 100% of net income; or
- a prior year of the estate so long as it qualified as the GRE in that year.

To be considered the GRE, the estate must elect GRE status in its first tax return. What if the gift is made before the estate has even filed its first tax return in which it would designate itself as the GRE?

For example, a gift by direct designation (i.e., charity is named as the beneficiary) under a life insurance policy can be fulfilled very quickly. In general, life insurance claims are paid promptly upon receipt of all required documents.

A positive response was received from the Canada Revenue Agency (CRA) in Technical Interpretation #2017-0684481E5. That is, CRA's view was that so long as the estate meets the definition of GRE at the time it files its first return of income, a gift given before filing will be afforded the flexibility described above regarding the use and timing of a donation tax credit.

Another issue that can impact the timing of claiming a donation tax credit as well as eligibility for a donation tax credit is related to the type of property that is donated. Many estate plans contemplate the donation of private company shares at death to mitigate the tax implications arising from the deemed disposition. The ability to claim the donation tax credit is contingent on whether the shares are considered non-qualifying securities (NQSs). An NQS is generally defined in subsection 118.1(18) of the *Income Tax Act*[1] as a share, debt obligation, or other security issued by the donor or a person not dealing at arm's length with the donor. For example, shares of a private company controlled by the donor, their estate, or someone not dealing at arm's length with the donor or their estate would be an NQS.

A gift of an NQS is not recognized as a charitable gift for tax purposes until the charity disposes of the NQS. The charity must dispose of the NQS within 60 months of receiving the gift for the gift to be recognized as a charitable gift at all. When the charity disposes of it, the value of the charitable gift[2] of an NQS is deemed to be the lesser of:

- the fair market value at the time of the original gift, and
- the amount the charity receives "as consideration" on the later disposition, other than consideration that it itself is an NQS

These rules do not apply if the charity is a public foundation or charitable organization with which the donor deals at arm's length.

The recent case of *Odette (Estate) v. The Queen* 2021 TCC 65 involved the gift of an NQS. In this case, the deceased, who died in November of 2012, made a gift by will of an NQS (private company shares held by the deceased) to a private foundation. The shares were transferred to the foundation in December of 2013, and within a few days, the corporation purchased the shares for cancellation in exchange for a $17.7-million promissory note. Since the promissory note was issued by a non-arm's length corporation, it was itself an NQS. Several months later the corporation repaid the promissory note in three tranches totalling $17.7 million of cash. The deceased claimed a $17.7 million charitable tax credit in their terminal return.

For deaths prior to 2016, as in the Odette case, a charitable donation made by will was deemed to be made by the deceased and could offset 100% of net income in the terminal return or the immediately prior year. Whereas gifts made by an estate could only be claimed against 75% of the estate's net income with a carry forward of five or 10 years (depending on the type of property that was given).

The CRA denied the charitable donation credit claimed in the terminal return on the basis that the promissory note issued on the redemption of the shares donated to the charity was itself an NQS and thus excluded from what would be considered consideration. The Tax Court agreed with the CRA and reviewed the NQS rules in the Act, which in 2012 were essentially the same as described above.

The estate argued that the words "any consideration" in paragraph 118.1(13)(c) should include both the promissory note and the cash the charity later received from the corporation on the repayment of the promissory note. The court did not accept this argument. The court looked at the words of the Act, the technical notes when these measures were enacted, and the context of the NQS rules and found the only consideration the charity received at the time of the disposition of the shares (i.e., at the time of the redemption) was the promissory note. The promissory note was an NQS, and consequently, the fair market value of the gift was nil. The court decision was a very bad result for the deceased as the expected terminal return tax savings from the donation credit would have likely been close to $9 million.

Imagine what could have happened here if corporate-owned life insurance was available to redeem the gifted shares. If that were the case, the gift made by will could have been fulfilled within a short timeframe after death and the disposition would have occurred using life insurance proceeds as consideration for the shares. Redeeming the shares with life insurance proceeds rather than a promissory note would have allowed the gift to be claimed in the deceased's terminal return. In addition, the corporation would have received a capital dividend account credit from the life insurance proceeds allowing the survivors to extract tax-free funds from the corporation in the future.

The moral of the story is form matters. Although the foundation ultimately did receive cash in a very short period, the temporary issuance of the promissory note on the redemption of the shares negated the tax benefit of the planning. Furthermore, life insurance can provide immediate liquidity to ensure that a client's estate planning is not frustrated. Now is a great time to speak to your clients about charitable giving as part of their estate planning. ©

Joël Campagna, is assistant vice-president, regional tax and estate planning, individual insurance, Central West & Atlantic Region, at Manulife Financial.

[1] *The* Income Tax Act, *R.S.C. 1985, c.1 (5th Supplement) (as amended) (the "Act"). Unless otherwise stated, all statutory references are to the Act.*

[2] *Pursuant to paragraph 118.1(13)(c) of the Act.*

Corporate-Owned Life Insurance — Probate Tax Issues?

by Kevin Wark, LLB, CLU, TEP

The tax rules governing the valuation of corporate-owned life insurance, for purposes of determining the fair market value (FMV) of private company shares on a shareholder's death,[1] are well established. Subsection 70(5.3) of the *Income Tax Act* (the Act) provides that in valuing the shares of the corporation, the FMV of any corporate-owned life insurance on the life of that shareholder (or the life of certain non-arm's length persons) is deemed to be the cash surrender value (CSV) of the policy immediately before death.

For example, assume Ms. A owns all the shares in Opco. Opco owns a $1-million life insurance policy on Ms. A's life. Ms. A passes away and at that time the CSV of the policy on her life is $50,000. In determining the FMV of her shares for purposes of the deemed disposition rules on death, only the policy's CSV ($50,000) should be considered. In other words, the death benefit payable under the policy is not relevant in determining the FMV of Ms. A's shares in Opco.

The Canada Revenue Agency has also indicated that the terms of a buy-sell agreement that determine the value of shares on the death of a shareholder may displace the rule in subsection 70(5.3) and govern share value on death. For example, if an agreement specifies a valuation formula for determining the purchase price of shares on the death of a shareholder, the value determined by that formula could govern the determination of the FMV of the deceased's shares for purposes of the Act.[2]

Determination of Probate Fees/Taxes

It might be assumed that a similar approach to valuing corporate-owned life insurance would be taken in determining the FMV of shares in a private corporation for probate tax purposes.[3] That is, only the CSV of a corporate-owned policy on the shareholder's life would be relevant in determining the value of shares in that corporation for probate tax purposes. However, a recent court action in Ontario signals that this assumption may not necessarily apply in the probate context.[4]

The facts leading up to the *Crichton* court action are as follows: Mr. Greaves was the sole shareholder of three private corporations that were the owners and beneficiaries of life insurance policies insuring his life. Mr. Greaves passed away and the shares of these three corporations became part of his estate. The estate trustees applied for and were granted probate.[5] Estate administration tax was paid based on the estimated value of the estate, including the shares in the three private corporations. However, in determining the value of the shares, the insurance proceeds payable to the corporations were *not* included. The estate trustees also provided an undertaking confirming they would file a sworn statement of the actual value of the estate once it was determined and pay any additional estate administration taxes.

There was a question of whether the value of the life insurance policies should increase the FMV of the three corporations for probate tax purposes, which would result in higher estate administration taxes payable by the estate. The Ministry of Finance (the Minister) offered to provide the estate trustees with an advanced tax ruling on this issue. However, this offer was declined and instead the estate trustees brought an application to the Ontario Superior Court seeking a determination of whether life insurance proceeds payable to private corporations should be included in the value of the shares for purposes of calculating Ontario estate administration taxes.

The Minister opposed this motion on the basis that there is a separate mechanism for taxpayer objections and appeals under the *Estate Administration Tax Act* (EATA).[6] The Minister argued that the proper way for the estate trustees to deal with this issue would be to self-assess (that is, take a position on value) and then wait until the Minister had assessed the tax payable by the estate. Only at this stage should the Court be engaged in considering the estate's appeal from such an assessment. The estate trustees challenged the Minister's position on the basis that the Court has an inherent jurisdiction to deal with functional gaps in legislation, such as in this present case where there has been no assessment, objection, or appeal that would engage the legislated objection/appeal procedures.

The Court reviewed the applicable legislative provisions and related case law and accepted the Minister's position that the current situation involved a tax dispute that fell squarely within the parameters of the EATA. The Court noted that this determination did not preclude the estate trustees from making a future appeal to the court if they ultimately disagreed with the Minister's assessment. The Court also indicated that this decision should not be construed as offering any opinion on the technical merits of the application.

CALU Request for Interpretation

Upon learning about this issue earlier in 2021, and prior to the release of this court decision, CALU had written to the Minister seeking its views on whether an insurance death benefit received by a corporation on the death of a shareholder should be included in valuing the deceased's shares for purposes of the estate administration tax.

CALU also asked the Minister to consider the situation where there is a buy-sell agreement that is triggered by the death of a shareholder, and there is a formula in the agreement for determining the value of the deceased's shares. We requested the Minister's views on whether the share value calculated by such a formula would be determinative of the value of the deceased's shares for estate administration tax purposes.

The Minister has now responded to CALU's request for an interpretation. The Minister indicated that it was not the government's policy to provide a binding interpretation regarding an unidentified client or situation. However, it was prepared to provide some general information that might be of assistance in understanding the administration of the EATA.

The Minister's response went on to state that the estate administration tax is payable on the value of the estate of a deceased if an estate certificate is applied for. Value of the estate means the value of all assets belonging to the deceased at the time of death, and not just assets for which probate is required. In the situation where the deceased owned shares in a corporation at the time of death, the value of those shares will need to be included in the value of the estate. The FMV of the shares needs to be

determined by the estate representative (and their accountant) and documentation evidencing the value produced if requested by the Minister.

Some clarification is required in relation to the Minister's response to CALU's request for an interpretation, as it may appear to suggest that all assets owned by the deceased must be included in the value of the estate for estate tax purposes. However, Ontario specifically recognizes the use of secondary wills.[7] Certain types of property that don't require probate to be administered[8] by the executors are typically included in a secondary will. The secondary will does not require probate and therefore no estate taxes are payable on property included in it.[9]

Conclusions

Neither the court decision in *Crichton* nor the Minister's response to CALU's request for an interpretation provide any certainty relating to the issue of the valuation of corporate-owned life insurance in determining Ontario estate administration taxes. There is also the broader question of whether similar interpretive issues could arise in other high probate tax jurisdictions such as British Columbia and Nova Scotia. As noted above, one way to avoid this issue in British Columbia and Ontario would be to have a secondary will governing the corporate shares, which does not require probate or the payment of estate taxes on the value of the corporate shares. Having a buy-sell agreement between the shareholders that specifies the FMV of a deceased's shares may also be determinative of the value of those shares for Ontario estate tax purposes. The FMV of fixed value preference shares (such as those issued under an estate freeze) would also not be influenced by future growth in the value of corporate assets resulting from the receipt of life insurance proceeds.

This issue will continue to be monitored. In the meantime, the potential for increased estate taxes should be considered by Ontario clients and their professional advisors when contemplating the purchase of corporate-owned life insurance. ©

Kevin Wark, LLB, CLU, TEP, is a tax advisor for CALU. He can be reached at kevin.wark@calu.com. Reprinted with permission from CALU.

[1] *As required under subsection 70(5).*

[2] *Refer to paragraphs 17-31 of Information Circular IC 89-3 dated August 25, 1989.*

[3] *Ontario levies an estate administration tax that is generally equal to 1.5% of the value of estate assets above a very low threshold.*

[4] Crichton v. Ontario (Minister of Finance) 2021 *ONSC 8012. Herein referred to as "*Crichton*".*

[5] *In Ontario this is referred to as a Certificate of Appointment of Estate Trustees with a Will.*

[6] *S.O. 1998, C. 34. Section 4.6(2) of the EATA incorporates by reference the appeals process under the* Ontario Retail Sales Tax Act, *R.S.O 1980, c. R.31.*

[7] *The other province is British Columbia.*

[8] *The secondary will would typically include the testator's personal property and shares of a private corporation.*

[9] *https://www.ontario.ca/page/estate-administration-tax. In circumstances where there is an Ontario estate with a secondary will, the estate executors would apply for a Certificate of Appointment of Estate Trustee with a Will Limited to the Assets Referred to in the Will. Only assets included in that specific will be included in the value of the estate.*

Benefits and Contributions for 2022

	CPP	QPP	OAS
CPP/ QPP Benefits (for new beneficiaries)			
Retirement pension (at age 65)	**$1,253.59**	**$1,253.59**	
Post-retirement benefit (at age 65)	**$36.26**	**n/a**	
Retirement pension supplement	**n/a**		
Disability pension	**$1,457.45**	**$1,463.83**	
Disabled contributor's child benefit (each child)	**$264.53**	**$83.99**	
Survivor's *** pension			
Under age 65	**$674.79****	**$955.61****	
Age 65 and over	**$752.15**	**$602.86****	
Surviving child benefit (each child)	**$264.53**	**$264.53***	
Death benefit (lump sum)	**$2,500**	**$2,500**	

Annual CPP contribution

Employee's annual contribution (5.7%)	**$3,499.80**		
Employer's matching of employee's contribution (5.7%)	**$3,499.80**		
Self-employed's annual contribution	**$6,999.60**		

Annual QPP contribution

Employee's annual contribution		**$3,315.60**	
Employer's matching of employee's contributions		**$3,315.60**	
Self-employed's annual contribution		**$6,631.20**	

Old Age Security (OAS)

January to March 2022			**$642.25**

Guaranteed Income Supplement (GIS)

January to March 2022			
Spouse/common-law partner receives OAS or allowance			**$577.43**
Single person (or spouse/common-law partner receives neither OAS or allowance)			**$959.26**

Allowance

Age 60 to 64 and spouse/common-law partner receives OAS and GIS			**$1,219.68**
Age 60 to 64, survivor's allowance			**$1,453.93**

NOTES: these figures are the maximums for the most part, with actuals depending on individual income/history according to context * flat benefit amounts ** these amounts may vary depending on whether the survivor is under age 45, disabled, or with or without children *** a survivor is the spouse or common-law partner of a deceased individual

COMMENT is an informative newsletter targeted to the unique niche that CLU advisors occupy in the financial services industry, with a focus on risk management, wealth creation and preservation, estate planning, and wealth transfer. COMMENT has been an integral part of the CLU environment since 1967.

Deanne Gage, Editor | info@iafe.ca