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COMMENT

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A Charitable Gift: Differing Tax Outcomes Can Affect the Plan

Charitable gift planning should involve the careful consideration of all aspects of making a large gift to charity. Some of the elements to be considered include the exact nature of the gift (i.e., cash versus a specific asset), the timing of the gift (i.e., all at once or in installments), whether the gift is *inter vivos* or testamentary, the income tax consequences of making the gift (i.e., realization of accrued capital gain or income), and the income tax benefits that could arise as a result of the gift (i.e. tax credits for individuals or deductions for corporations). The donor's expectations can have a significant influence on whether a charitable gift is completed.

Examples of the tax consequences that could arise upon making an in-kind charitable gift include:

- Realization of the accrued capital gain but a zero income tax inclusion rate. This would be applicable for gifts of publicly-traded securities and certain other capital properties.
- Realization of the accrued capital gain with a "normal" 50 percent inclusion rate into taxable income. This would be applicable for gifts of most other capital property.
- Realization of the accrued gain with a 100 percent taxable income inclusion rate. This would be applicable to gifts of inventory or life insurance policies.

The distinction between a gift of capital property and a gift of inventory can be contentious because of the significant difference in income tax consequences. This issue arose in a recent case, *Mario Staltari v. The Queen*, before the Tax Court of Canada.

The facts of the case are as follows:

- Mario Staltari donated a piece of land to the City of Ottawa in 2009 and claimed the realized gain on account of capital on his personal tax return.
- Throughout his career, Mario was a real estate broker and had accumulated significant wealth in the form of rental properties and investments.
- Mario bought the piece of rural farm land in question from his father in 2000 for $70,000 at the request of his father who was retired and wanted the cash flow to help meet his retirement needs. The father had purchased the land years earlier with no intention of developing the property.
- From 2003 to 2005, Mario actively investigated the possibility of developing the land, spending about $293,000 on such investigations. However, at some point in the process, the Ministry of Natural Resources became involved because they thought the land could be environmentally sensitive.
- Mario approached the City of Ottawa and negotiated the gift of the land to the city. The land was appraised by an independent valuator at $1,935,000. The Minister of the Environment certified that the land was ecologically sensitive.
- Mario filed his 2009 tax return claiming the disposition of his land with no resulting income or taxable capital gain because there is a zero inclusion rate for gains realized upon the gift of ecologically sensitive land. In addition, Mario claimed the value of the gift as a charitable gift and used $875,000 of the gift amount on his 2009 tax return.

The CRA assessed Mario on the basis that the land donated was inventory and not capital property and therefore did not qualify for the zero capital gain inclusion rate but rather the gain should be fully taxed as income. In explaining its position, the CRA cited Mario's experience in the real estate industry and his attempt to develop the land as indications of his intentions with respect to the property.

Mario appealed the CRA's assessment and the case proceeded to the Tax Court of Canada. The judge sided with the taxpayer and allowed the gain to be treated as a capital gain which resulted in a zero inclusion rate. In reaching his decision, the Tax

Court judge determined that in respect of the land Mario did not demonstrate any business activities, such as a business plan, a marketing plan or overall strategic plan. Mario was not known in the business community as a real estate developer, but rather as a real estate broker, and the steps he had taken to subdivide and rezone the land did not in and of themselves indicate the existence of a business.

Supporting the charitable sector is important to the overall health of society. Charitable gift planning can assist in this objective by ensuring that significant gifts are properly planned to maximize the value of the gift to society and minimize the cost to the taxpayer.

Interest Expense

The Canada Revenue Agency (CRA) recently released an updated folio publication on the topic of interest deductibility. This is part of the CRA's new Income Tax Folio series, which is designed to provide details of their current administrative practices and is targeted at the professional tax community.

Folio S3-F6-C1, released in 2015, sets out the CRA's position on the deductibility of interest expense under paragraph 20(1)(*c*) of the Income Tax Act ("ITA") along with related provisions. The predecessor document, Bulletin IT-533 – *Interest Deductibility and Related Issues*, was originally issued in 2003.

Generally, interest expense is considered to be a capital expenditure and is deductible only if it meets the specific requirements as set out in the ITA. The provision that allows the deduction of interest expense, paragraph 20(1)(c), appears relatively straightforward but differences in interpretation often lead to wording being argued before the courts.

The general principles for interest deductibility include the following:

1. The interest amount must be paid or payable in a taxation year.
2. There must be a legal obligation to pay the interest amount.
3. The money must be borrowed for the purpose of earning income from a business or property (even if that income does not materialize), but this provision excludes interest on money borrowed to acquire a life insurance policy and limits the amount deductible in respect of money borrowed to purchase an annuity.
4. The deductible amount must be reasonable in the circumstances.

As noted in point three above, the provision includes a purpose test. In simple terms, this purpose test obligates the taxpayer to demonstrate how the funds were utilized, and has been the subject of significant litigation over the years. The new folio reflects precedents arising from court decisions such as *Ludco Enterprises Ltd. et al. v The Queen*. In Ludco, the Supreme Court of Canada confirmed a taxpayer's ancillary purpose is an acceptable purpose to allow for deductibility of an interest expense. The term "used" is interpreted to mean used directly or indirectly, again based on case law precedents.

Borrowing To Purchase An Annuity

As noted above, interest on money borrowed to purchase an annuity may be deductible in certain circumstances. Specifically, the annuity must be subject to annual accrual taxation, and if regular annuity payments have commenced under the contract, the interest deduction is limited to the amount of income that is included in the taxpayer's income under the accrual taxation rules. Note that many annuities automatically qualify as "prescribed annuity contracts" once they enter into their payout phase, with the result that interest will no longer be deductible on these contracts unless the policyholder elects out of prescribed annuity treatment.

Borrowing to Buy Common Shares

The folio requires that the "purpose" test be met in order for interest expense to be tax deductible. Formerly, this was known as the "reasonable expectation" test. The CRA's position is that generally interest on funds borrowed to purchase common shares is a deductible expense, provided there is a reasonable expectation of dividends payable on the shares. The purpose test cannot be met if the company has a stated policy of NOT paying dividends. In situations where the company has never paid dividends, the purpose test can generally be met as long as the company policy is silent with respect to dividends, or if the policy provides that the company will pay dividends when operational circumstances permit.

Participation Payments

A participation interest payment might be part of a legal agreement to pay interest or 'extra' interest calculated with reference to profits, revenues, cash flow, etc. To be treated as interest, there

must be a legal obligation to pay the amount and it must be in respect of the amount borrowed.

Compound Interest

There is a specific provision that denies the deduction of compound interest until it is actually paid. Compound interest is interest on interest – in other words, it is interest arising on a balance of interest payable that has been added to an existing loan (or "capitalized") rather than being paid. Adequate records will be required to separate the basic interest that becomes payable and deductible from the compound interest that is not deductible until actually paid. The folio confirms the CRA's practice of allowing interest on a second loan incurred to pay the interest on the first loan to be deducted for tax purposes.

Tracing

The taxpayer must be able to trace the use of the borrowed funds to an eligible purpose. This is usually relatively easy when the funds are first borrowed. Complexity can arise if the income-producing property is sold and replaced with another property. If the purpose of the second property acquired is to gain or produce income, then the interest on the loan continues to be tax deductible.

Borrowing funds can be key to business expansion or portfolio diversification and the deductibility of the associated interest will be important to the taxpayer in assessing the overall after-tax rate of return. The CRA's interest deductibility folio provides insight and some certainty into their administrative positions.

Joint Tenancy Can Add Complications

Distribution of an individual's estate can take many forms. Assets can be gifted before death or distributed after death. Specific assets can be directed to specific heirs or the residue of the estate could be divided among a group of heirs. Methods for achieving these distributions can vary.

A common estate planning strategy in Canadian common-law provinces is the use of shared ownership. Property titles can be registered as "joint tenants with rights of survivorship" or "tenants in common".

A "tenants in common" strategy provides each owner with an undivided interest in the property, allowing each to deal freely with their interest. As such, each of the tenants in common can bequeath their personal share of the asset through their personal will.

Assets held in "joint tenancy" pass automatically to the surviving tenant(s) upon the death of one owner. This automatic transfer allows the surviving owner(s) to assume direct title of the asset at the time of the testator's death. The asset does not pass through the testator's estate. The benefit of this type of property title is the opportunity to avoid the need for probate, which results in public disclosure of the estate's assets, it may place assets within the reach of creditors, and, in some provinces, result in probate fees.

The strategies sound simple. However, lack of documentation or clarity around intentions can cause complications. For example, there are situations where an individual may place an asset into joint tenancy with the intention of making the after-death transfer more efficient through the avoidance of probate. The testator may nonetheless intend that the joint tenant share the property with the other beneficiaries of the testator. A recent decision of the Ontario Court of Appeal (*Mroz v. Mroz*) highlights the challenges of a joint tenancy strategy.

In 2004 Kay Mroz executed a new will and simultaneously transferred title of her home into joint tenancy with her adult daughter, Helen. The property transfer resulted in Kay and Helen owning the home in joint title although Kay's lawyer had recommended title be registered as tenants in common. There was an inter-relationship between the transfer of the home into joint title and the bequests set out in Kay's Will.

In her will, Kay bequeathed her share of the property (which she now owned jointly with Helen) to Helen provided that within one year of her death, Helen pay $70,000 to each of Kay's grandchildren Adrianna and Martin (the children of Kay's deceased son). It was noted in the will that "these legacies shall constitute a first charge on my property in favour of Adrianna and Martin until the legacies are paid." In addition, Kay bequeathed $50,000 to her nephew Richard and his family. Helen and Richard were named as executors of Kay's estate.

A short time after Kay's passing in 2005, Helen, as the sole owner of the property, sold the home for approximately $476,000 and retained the proceeds. The property passed to Helen outside of the estate and she chose not to discuss the transaction with Richard, the co-executor of the estate. Apart from the property, Kay's estate was valued at about $3,200.

Martin and Adrianna immediately undertook legal proceedings, challenging the validity of the 2004 will. The outcome of the initial trial resulted in a decision that upheld the validity of the will but required Helen to pay the $70,000 amounts owing to each of Martin and Adrianna. The trial judge found that Helen had successfully refuted the presumption of creation of a resulting trust at the time the property was transferred into joint title. However, the trial judge found that Kay had created a testamentary obligation on Helen, and ordered that Helen pay the amounts owing to Kay's grandchildren as outlined in the will.

Helen appealed the court's decision, arguing that she should receive the property outright (with no liability to pay the grandchildren) because the trial judge found there was not a presumption of a resulting trust. The grandchildren also appealed, arguing that the trial judge was wrong in his decision with respect a resulting trust.

The appeal judge reaffirmed the trial court's decision that the will was valid, and that there was no undue influence asserted by Helen when Kay chose to make testamentary changes in 2004.

The appeal court, however, disagreed with the trial court and found that Helen held the property on resulting trust. Earlier precedence set out in *Pecore v. Pecor*e found that "When a parent gratuitously transfers property to his or her adult child, the law presumes that the child holds the property on resulting trust for the parent. The burden of rebutting the presumption is on the child." It is up to the courts to weigh the evidence in attempting to ascertain the parent's intentions at the time of the transfer. In the Mroz case, the appeal court found that the evidence indicated that Helen was to use the proceeds from the sale of the property to fund bequests set out in the will. As such, when Kay passed, the property formed part of her estate. The trust obligation only arose at the time of Kay's passing and, as such, was testamentary in nature.

The appeal court concluded that the property formed part of Kay's estate on her passing and should have been disposed of in accordance with her will. Helen had an obligation to sell the property and use the funds to complete the $70,000 bequests owing to each of Martin and Adrianna. Failure to do so was a breach of trust by Helen.

This was an important decision that adds clarity to the issue of joint tenancy. The judge concluded that had the presumption of a resulting trust been rebutted, "then the transfer of the Property was an *inter vivos* gift and Helen became solely entitled to the Property on Kay's death by virtue of the right of survivorship. In that case, the Property would not have formed part of Kay's estate and Helen would have no legal obligations in relation to the Property or the proceeds of its sale."

Using joint title with the right of survivorship can be a valuable tool under some circumstances; however, care should be taken to understand all of the potential implications. While not discussed in this article, there could also be issues of a family law nature in respect to the child and child's spouse, and tax implications of transferring the property into joint title. The Mroz case highlights the value of ensuring a testator's wishes are well documented and understood by all parties. Even when a testator is clear as to his or her wishes, emotions can give rise to tremendous upheaval within families, particularly at the time of a parent's passing. Simple decisions can become complicated court cases long after the estate plan was put in place.

Contributors to this issue of Comment:

James W. Kraft, CPA, CA, MTAX, TEP, CFP, CLU, CH.F.C.
Deborah Kraft, MTAX, TEP, CFP, CLU, CH.F.C.

Published by:
The Institute
390 Queens Quay West, Suite 209
Toronto, Ontario M5V 3A2
T: 416.444.5251 or 1.800.563.5822
F: 416.444.8031
www.iafe.ca • info@iafe.ca

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