

CHARITABLE REMAINDER TRUSTS:

**Dying for an immediate charitable tax receipt
without the "pain" of an immediate, or any, charitable gift.**

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CHARITABLE REMAINDER TRUSTS: Dying for an immediate charitable tax receipt without the "pain" of an immediate, or any, charitable gift.

I. The U.S. Charitable Remainder Trust is at the border

A charitable remainder trust (CRT) is an irrevocable trust into which a settlor or donor can transfer property. The settlor, or someone else designated by the settlor, retains an income interest in the property while a registered charity holds the residual or capital interest. The CRT holds legal title to the property. The settlor receives a charitable donation receipt for the fair market value of the residual or capital part of the gift and the settlor receives income from the CRT on an annual basis. The settlor pays income tax on that income. Upon the death of the settlor, or after some fixed period of time, the settlor's interest terminates and the charity retains the capital interest.

There have been a number of recent articles dealing with the charitable remainder trust (CRT) in Canada, including articles by authors Blake Bromley¹, Carole Chouinard², Wolfe Goodman³ and Robert Kleinman⁴. Most of the articles look enviously at the

¹ Blake Bromley. "Creative Planning of Charitable Donations." *Report of Proceedings of the Forty-Eighth Tax Conference, 1996*, Toronto: Canadian Tax Foundation, 1997, p. 56:1-47 ("Bromley")

² Carole Chouinard. "Comparison of the Tax Treatment of Charitable Remainder Trusts in Canada and the United States". (1998) 14 *Philanthrop* 3, pp. 3-16 ("Chouinard")

³ Wolfe D. Goodman and Lisa R. Simone. "Charitable Remainder Trusts: A Canadian Perspective". *Charity and Not-For-Profit Law: The Emerging Specialty*, Canadian Bar Association, May 15, 1997, pp 1-12 (referred to in this paper as "Goodman")

⁴ Robert A. Kleinman, C.A. "The National Jewish Gift Planning Handbook." Council of Jewish Federations of Canada and the United Israel Appeal of Canada, Montreal, 1998. ("Kleinman")

generous U.S. tax rules dealing with CRTs and suggest that Canada follow the U.S. lead and implement generous CRT rules. Recently, the U.S. Internal Revenue Service (I.R.S.) has cracked down on the rampant abuse of CRTs. In this paper, I will use tax expenditure analysis to argue that if the ostensible purpose of CRTs is to encourage the gifting of large assets to charities, then the CRT is an ineffective method of accomplishing this goal, and there are other more obvious and direct ways to reward donors. The Ministry of Finance and the Canada Customs and Revenue Agency (the "CCRA"⁵) should maintain the current restrictive, yet fair, rules on CRTs and avoid the abuses that have taken place in the U.S. with such trusts.

II. The U.S. Experience with CRTs

In 1969, Section 664 of the United States' *Internal Revenue Code of 1986* (the "IRC") introduced various new requirements for a valid CRT that would be recognized by the I.R.S.. Although an American taxpayer does not have to create the CRT according to the Section 664 rules, non-compliance will result in numerous penalties, including no charitable tax receipt and the triggering of a capital gain. These heavy incentives, therefore, make compliance essential from a financial point of view.⁶

A qualified US CRT is an irrevocable trust that requires the trustees to distribute at least annually, to one or more non-charitable beneficiaries, until the death of the last of

⁵ The CCRA was formerly Revenue Canada.

⁶ The CRT must also not have any unrelated business taxable income (UBTI) in order to be qualified CRT. If a trust has UBTI then the entire income and gains of that year is subject to income tax. See Howard McCue "Charitable Remainder Trusts: A Little UBTI Goes a Long Way" (1996) 3 *Trusts & Estates* 14.

them, or for a fixed number of years, but not greater than 20 years, either a fixed dollar amount or a fixed percentage amount. When the interests of the non-charitable beneficiary or beneficiaries cease, the trust distributes the remaining assets to the charity or charities.

There are 3 major types of U.S. CRTs⁷:

1. Charitable Remainder Annuity Trusts (CRATs)

The CRAT is a CRT that annually pays a fixed dollar amount to the income beneficiary. If the payout to the income beneficiary is greater than the growth rate of the asset, then there is a possibility that the charity will receive nothing at the termination of the trust. In order to reduce the likelihood of this occurrence, the IRS has added the "not so remote as to be negligible" requirement with respect to CRATs. This requirement stipulates that there cannot be a probability of greater than 5% that the income beneficiary will survive the exhaustion of the CRT's assets⁸. There is also a minimum 5% annual payout requirement. Once the CRAT is formed no further assets can be contributed.

2. Charitable Remainder Uni-Trust (CRUT)

The CRUT is a CRT that pays the income beneficiary an amount based on a fixed percentage of at least 5% of the CRUT's annual fair market value. The CRUT can receive further contributions of property from the settlor, unlike the CRAT.

⁷ Howard Pearson. "Charitable Remainder Trusts and Other Charitable Techniques". *Practicing Law Institute* (1999) 283 PLI/Est 967 at 975.

3. Net Income Charitable Remainder Uni-Trust (NIMCRUT)

A variation of the CRAT and CRUT is the NIMCRUT which is a CRT that annually pays the lesser of a fixed percentage of the trust's annual value or the actual net income earned during the year to the income beneficiary.

A U.S. CRT can provide one or more of the following benefits⁹: the settlor receives a charitable income tax deduction which depends on the remainder value; the charity will receive a residual capital interest in the future, if there is one; a settlor avoids capital gains taxes on his or her appreciated assets; the settlor can avoid estate/death taxes by lowering the value of his or her potential estate¹⁰; assets in a CRT are protected from the settlor's creditors; there is increased cash flow compared to a sale of the assets and then receiving income from a smaller after tax asset; and the settlor can ensure an income stream for life, or for a certain number of years.

In the U.S. CRTs are a big business. CRTs are widely used in the U.S. as a tax avoidance and estate planning vehicle. Generally, the income tax receipt is used to avoid income tax when the taxpayer has a significant income, and, then the taxpayer receives the distributions of income from the CRT later in life when his or her income will be

⁸ William L. Hoisington. "The Truth About Charitable Remainder Trusts". (1992) 45 *Tax Lawyer* 293 at 294.

⁹ L.S. McCullough. "Charitable Remainder Trusts" (1996) 4 Utah Bar Journal 8.

¹⁰ Currently U.S. taxpayers have to pay a progressive tax rate from 18-55% on the value of their estate over US\$650,000.00.

much lower.¹¹ Usually the assets placed in a CRT are highly appreciated capital assets, and when the CRT disposes of these assets it is able to avoid the capital gains tax. A cursory scan of the internet will show U.S. universities¹² encouraging alumni to donate by way of CRT, financial advisors who tout the tax benefits of setting up a CRT, and even software developers who market programs that can create CRTs without the need for legal assistance.

III. The U.S. Abuse and I.R.S. Crackdown

In July 1997, the I.R.S announced that it was tightening up the rules for CRTs¹³ in response to persistent abuse by some taxpayers. Wealthy individuals have used the CRT to simply avoid paying capital gains on highly appreciated assets. With clever names like the "Turbo-Charged Unitrust"¹⁴ a settlor could use a CRT to almost completely avoid capital gains taxes on the appreciated assets over a very short period, such as two years, with no benefit whatsoever to any charity, and a huge loss of potential revenue to the government.

The IRS introduced two additional requirements to curb significant abuses of the CRT rules. In addition to the 5% requirement discussed above there is a new 10%

¹¹John Petroff, "The Charitable Remainder Trust: Is there a better way to make a large donation". New York University, Graduate School of Business Administration, April 1974 at p. 10

¹² Anecdotal examples include the web sites of Cornell University (www.cornell.edu) or Temple University (www.temple.edu). Both universities cite \$50,000 U.S. as the minimum donation for a CRT.

¹³ Conrad Teitell. "Congress Says, "Show Me The Charitable Gift."" (1997) 10 *Trusts & Estates* 73 at 73-81.

minimum remainder interest requirement. For both the CRAT and the CRUT there is now also a ceiling of a 50% annual payout of the net fair market value of the property. Any CRT that does not meet these new requirements must either be changed so as to qualify, or the CRT is declared null and void *ab initio*. Some of the CRTs will not meet these new requirements and in some cases significant appreciated property that will have been transferred to the non-qualifying trusts will now be taxable to either the donors or the trust. The new rules will curtail some of the most egregious abuses of the CRT in the U.S..

IV. IT-226R: The Mellow Canadian CRT

Unlike the IRC rules the *Income Tax Act (Canada)*¹⁵ makes no specific reference to CRTs. The CCRA's *Interpretation Bulletin IT-226R*¹⁶ discusses the CCRA's administrative position with respect to trusts of these sorts, although the term 'charitable remainder trust' is not used in that document. According to paragraph 1 of IT-226R the gift of "a residual interest in real property or an equitable interest in a trust to a registered charity ... may qualify as ... a non-refundable federal tax credit, if donated by an individual." Paragraph 2 requires that there be an irrevocable "gift", that the property must vest with the charity, that there be "no expectation of right, privilege, material benefit or advantage" to the settlor, or person designated by the settlor, and it must be

¹⁴ Howard M. McCue. "Attack on Charitable Remainder Unitrusts Creates Uncertainties". (1994) 12 *Trusts & Estates* 25 at 25-28.

¹⁵ R.S.C. 1985, c.1 (5th Supp.), hereafter referred to as "the Act".

¹⁶ *Interpretation Bulletin IT-226R*, "Gift to a Charity or Residual Interest in Real Property or an Equitable Interest in a Trust", November 29, 1991.

evident that the charity will receive full ownership and possession of the property. There also needs to be a valuation and the issuance of an official donation receipt. Paragraph 4 allows that the trust can either be *inter vivos* or testamentary and that there should not be any power to encroach upon the capital of the trust. Paragraph 5 sets out a general statement on valuation of the residual interest while paragraph 6 states that where the residual interest "cannot reasonably be determined" then no deduction or tax credit will be allowed. Paragraph 8 deals with the scenario of the fair market value of the property exceeding its adjusted cost base at the time of disposition; it allows the taxpayer or its legal representative to make an election under Section 118.1(6) of the Act of an amount, not greater than the fair market value and not less than the adjusted cost base, to be used as both the proceeds of disposition and the amount of the gift.

In Canada, a "charitable trust" must devote all of its income and capital to charitable purposes in order to be exempt from taxation. Therefore the CRT by definition is not a charitable trust. If a trust devotes any of its income to a non-charitable purpose, even if the remainder is for a charitable purpose, then the trust is treated as a regular trust for purposes of taxation and not a charitable trust, and the regular trust is subject to taxation.

As the CRT is not a charitable trust in Canada so the transfer from a donor to a CRT of appreciated capital property would be a deemed disposition and the donor would have to pay capital gains tax on the disposition for the year of the gift.¹⁷ Furthermore, the CRT is subject to the rule against perpetuity and the 21-year deemed disposition rule.

¹⁷ Goodman, p. 10. As discussed by Goodman on p. 10 in *C A Ansell Estate v. MNR* [1966] CTC 785 even if a CRT disposes of the capital asset at a later date the trust is not

In Canada, unlike the U.S., it is most advantageous, from a tax perspective, to donate assets to a CRT that on disposition will not incur any capital gains, either because they have not appreciated in value, or, as in the case of a principal residence, the growth is exempted from capital gains tax. With such a property although there would be a disposition on transferring the asset to the CRT, this would result in little or no capital gains tax, the donor would receive a charitable donation receipt which would reduce taxable income, and the taxpayer would receive a future income stream while ensuring that the asset makes it to the charity of choice.

The benefits of using a CRT in Canada are as follows: the tax receipt the taxpayer receives; the residual interest the charity receives; the donor's asset is protected from the donor's creditors; the assets is not part of the estate of the donor and therefore excluded from the calculation of the probate tax; and the donor receives an income stream for life. However, the CRT in Canada, is not a windfall for those wishing to avoid estate fees¹⁸ and capital gains taxes, as is the case in the U.S..

The CRT is especially useful for elderly taxpayers. It allows them to make a contribution to charity, relieves them of the burden of dealing with the management of an asset or assets that they may no longer be able to administer and provides assured income until their death.¹⁹ Bromley asserts that another reason for an inter vivos gift to a

exempt from the capital gain as the regular tax rules apply to the CRT even though the ultimate beneficiary of the capital asset is a charity.

¹⁸ In Canada there are no estate/death taxes and the probate taxes are relatively low. For example in Ontario, under the *Estate Administration Tax Act*, 1998, the probate tax for amounts between \$1,000 and \$50,000 is 0.5 percent and amounts over \$50,000 is 1.5%.

¹⁹ Petroff, p. 18.

Canadian CRT, other than the immediate tax receipt and income for life, is that there is less likelihood that a "greedy" relative could have the gift set aside by litigation.²⁰

V. Canadian CRT Articles

There are only four Canadian articles dealing with CRTs, and they are all written from a practitioner's point of view. Goodman, Chouinard, and Bromley are all proponents of more generous U.S.-style rules for CRTs in Canada; whereas, Kleinman is content to use the CRTs as they are currently allowed. Goodman, Chouinard and Bromley are lawyers who practice in the tax or estate areas. Kleinman is an accountant who works for a sophisticated charity.

Goodman, Chouinard, and Bromley are all envious of the generous U.S. tax rules and critical of the CCRA's restrictive administrative position in IT-226R. Bromley pointedly notes that the Ministry of Finance should "allow Canadian donors to charitable remainder trusts the same favourable treatment extended to donors in the United States".²¹ Goodman states that:

In light of these problems, it is hardly surprising that, notwithstanding the determined efforts of a number of its proponents, the charitable remainder trust is not generally utilized in Canada. It may, however, be useful for individuals who are not motivated by a present tax incentives, but by the security that a CRT affords that the individual's charitable intentions will not be frustrated.²²

²⁰ Bromley, p 56:16.

²¹ Bromley, p. 56:15.

²² Goodman, p. 12.

There is no question that if US style CRT rules are brought into Canada, then this would provide a tremendous benefit to some of the above practitioner's clients and to many legal and accounting practices.²³ What is less certain is if there would be any benefit to Canadian charities, the Canadian government and the Canadian society.

VI. CRTs as a Tax Expenditure

For the purpose of analysis, the CRT can be classified as a tax expenditure. Tax expenditures are incentives and preferences that are given through the tax system that could also be given through direct expenditures.²⁴ A tax expenditure can also be conceptualized as a revenue loss caused by an exclusion, deduction or credit that deviates from some benchmark tax system.²⁵ Tax expenditures, unlike spending provisions, are not however included in the annual budget.

The Department of Finance annually publishes a list of tax expenditures. In the 1999 list, the personal income tax expenditures include an estimate for 1999 of \$1.35 billion for charitable donations credits and \$100 million dollars for the reduced inclusion

²³ It is beyond the scope of this paper but Canadian residents who have significant U.S. income can claim any allowable U.S. charitable contributions up to 75% of the U.S. source income. Further, those Canadians who live near the U.S. border and who commute to the U.S. for their principle work can use the U.S. charitable receipts to offset up to 75% of their world income. See "Gifts and Income Tax", Canada Customs and Revenue Agency P 113(E) Revised 1999

²⁴ Examples of other major tax expenditures include the R.R.S.P., the child tax benefit, non-taxation of business paid health and dental benefits and the \$500,000 lifetime capital gains exemption for small businesses.

²⁵ Harvey S. Rosen, et al. *Public Finance in Canada*, Toronto: McGraw-Hill Ryerson, 1999, p. 22 and 551-554.

rate for capital gains arising from certain charitable donations.²⁶ CRTs are not counted separately and the tax receipt generated by the donation of the property to the CRT would be included in the \$1.35 billion dollar figure along with the other donations to charities. There is no way of calculating exactly how much of the \$1.35 billion dollar estimate is as a result of CRTs, although, judging from the comments of Bromley, Goodman and Chouinard, it is likely that the figure would be quite low. Some have criticized the use of the tax expenditure analysis, but it is a useful tool in analyzing preferences such as the CRT.

The major criticisms of tax expenditure analysis are as follows: first, some argue that it assumes that if a particular credit or deduction was available the taxpayer would have to pay that amount more taxes when in many cases taxpayers would adjust their behaviour to avoid the taxes; and secondly, for there to be a "loss" of income then there needs to be a ideal tax base or benchmark by which the income of government could be measured.²⁷ Neither of these arguments is particularly compelling. It is useful to know the approximate value of a tax expenditure so that intelligent choices can be made with respect to the value of the tax expenditure. With respect to a benchmark of income there is the Haig-Simons definition of income which holds that income equals consumption plus gain in net worth over a taxation year. The Haig-Simons definition is widely accepted as an equitable standard for income tax purposes.²⁸

²⁶ Department of Finance. Government of Canada Tax Expenditures, 1999.

²⁷ See Rosen, pp. 553-554.

²⁸ Peter Hogg and Joanne E. Magee. *Principles of Canadian Income Tax Law*, p. 136 citing Haig's *The Federal Income Tax* (Columbia University Press, 1921), p. 54 and Simons, *Personal Income Taxation* (University of Chicago Press, 1938), p. 50.

VII. Tax Expenditure Analysis

A tax expenditure analysis can include some of the following questions:²⁹ What government purpose is served by the spending provision and is it a valid government purpose? What other policy instruments might the government use to achieve this same purpose? Is it target efficient? Who benefits from it? Is it simple to administer and comply with? Does it appear to systematically disadvantage some group of individuals?

Although Goodman, Chouinard, Bromley and Kleinman do not directly attempt to address the tax expenditure questions as outlined above, some of these issues are touched upon in their articles and in those of some U.S. commentators.³⁰ In this paper I will use, the tax expenditure analysis to review the CRT, and to a limited extent, the tax credit for charitable donations. I will also discuss whether the current, supposedly unattractive, Canadian CRT rules are in fact better than the "attractive" U.S. CRT rules.

1. The CRT's purpose and is it valid?

Over the last few years all levels of Canadian government have been drastically cutting spending. These spending cuts have resulted in many programs being reduced or ended including programs that assisted the most needy in Canadian society, such as subsidized housing, employment insurance and mental health. Fiscal conservatives argued that the

²⁹ These questions were suggested by Prof. Neil Brooks of Osgoode Hall Law School in his course Tax Policy, Statutory Interpretation, and the Foundation of the Taxation of Individuals.

spending cuts were necessary to eliminate fiscal deficits, reduce debt, and to offer tax cuts. Certain elements of the voluntary sector have attempted to fill the huge void created by these changes, with little success.

The Federal government, after some would say abandoning health, education and the most needy in our society, has decided to assist the voluntary sector assume some of the governments former responsibilities by encouraging donations to the voluntary sector by various changes to the *Act*. The Federal government has increased the allowable limit of charitable donations from 20% to 75%³¹ per year and given preferential capital gains tax treatment to donations of "Qualified Securities". The capital gains inclusion rate for donations of these "Qualified Securities" (primarily shares in certain public corporations listed on certain stock exchanges and shares of mutual funds) between February 1997 and before the year 2002 has been reduced from 75 percent (3/4) to 37.5% (3/8).³² Bromley and Chouinard explicitly support increasing the level of funding to registered charities by changes to the Canadian CRT rules. They view the CRT rule changes as an extension of the other measures adopted by the Canadian government to promote charitable giving.

³⁰ They in fact do little public policy analysis. Goodman and Chouinard mainly focus on U.S. situation and only a small part of their articles deal with CRTs in Canada. Bromley and Kleinman are the two authors who focus predominantly on the Canadian context.

³¹ As a result of the 1996 and 1997 Federal Budgets the upper limit for charitable donations that could be used to offset annual income was increased from 20% to 75% of net income for the year. The upper limit for the year of death and the year preceding the year of death was raised to 100% of income. This provision provides an added incentive for individuals to make testamentary gifts in their will. See Michael J. Fremes. "Strategies for Charitable Giving". 1998 Ontario Tax Conference p. 12.

³² This applies to donations to certain qualified donees, but not to private foundations. See Bruce D. Ball and Brenda R. Dietrich. "Rewards for the Generous: A Review of Recent Tax Changes for Charitable Donations" 46 Canadian Tax Journal 415-441 at p. 425.

Many commentators and social activists are concerned with the trend to download important social programs from the government onto the voluntary sector. Many of the large social and economic issues such as the relief of poverty and ending homelessness are too large for the voluntary sector to deal with effectively. The amount of resources and knowledge is great and it requires a coordinated approach. A national government is in a better position to implement such programs in response to these challenges compared to the voluntary sector.

However, in spite of these concerns, the federal government seems determined to provide additional support to the voluntary sector. The next issue is whether the CRT is the best vehicle to facilitate large contributions to the voluntary sector.

2. Other better policy alternatives

If the government is interested increasing the amount of money at the disposal of registered charities then there are numerous superior alternatives to using U.S.-style CRT to encourage charitable giving.

The first alternative is to eliminate the charitable deduction and replace the lost charitable revenues with direct government funding.³³ This radical suggestion is unlikely to be implemented in the current political climate.

A second alternative, the encouragement of the donation of appreciated publicly listed securities, has already been implemented by the 1997 Federal Budget. As

³³ See Neil Brooks. "The Role and Financing of the Voluntary Sector in a Modern Welfare State". A paper prepared for "Charities: Between State and Market" Conference, Toronto, January 19, 1999.

explained below the donations of Qualified Securities are a far superior vehicle by which to encourage donations to the voluntary sector compared to the U.S.-style CRT. This recent change in the Federal budget has been criticized in terms of horizontal and vertical equity in that it provides a preference to those who donate Qualified Securities over other gifts like cash, and also because wealthier people are more likely to have Qualified Securities than middle or lower-class individuals. Although there is some validity to these vertical and horizontal equity concerns, there is no question that there are far more taxpayers who have Qualified Securities that they could donate to a charity compared to the number of people who would have assets that would be large enough to warrant the creation of a CRT. Furthermore, the Qualified Securities are easy to value and easily marketable, unlike many assets that can be placed in a CRT. The most important benefit is that the charity receives the Qualified Security with no strings attached and can immediately sell it, unlike the capital asset in a CRT, which may only be available to a charity decades later. This ease of valuation and liquidity is very useful to charities, especially smaller charities, many of which are not sophisticated in dealing with financial instruments or vehicles.

A third alternative to the CRT could be encouraging charitable gift annuities.³⁴ The charitable gift annuity is created when the donor contributes a sum of money to the charity and the charity then purchases an annuity. The annuity gives the donor an annual guaranteed amount for the life of the donor. This type of gift is dealt with in the CCRA's Interpretation Bulletin IT-111R. The charitable gift annuity ensures the donor an income stream for life and a charitable receipt for the difference between the donation and the

³⁴ Kleinman, p. 5.1.

expected income stream based on mortality tables. The charity is assured of receiving the amount of the charitable receipt, and the charitable gift annuity is less expensive to set up compared to a CRT, and, there is less likelihood for abuse compared to the U.S.-style CRT.

A fourth alternative to the U.S.-style CRT, but which can only be realistically used with certain assets such as a principal residence, is to directly gift the residual interest to a charity and avoid the administrative and legal complexity of a trust.³⁵ The donor will receive an immediate tax receipt and also be able to use the property for life. If the property is a principal residence, then the disposition will not create any capital gains tax consequence. Another possibility is to simply gift the capital property to the charity without a life interest in which case you receive the full charitable tax receipt.

There are many other attractive alternatives for donors to make capital contributions to registered charities, without the tremendous possibility of abuse that is inherent in the U.S.-style CRTs.

3. Is it target efficient?

There are currently 75,000 registered charities in Canada including charitable organizations, public and private foundations.³⁶ The allowance of charitable tax credits to taxpayers is not an efficient way to target limited resources to the most important priorities including education and healthcare or the most in need. About 57% of the

³⁵ Kleinman, p. 11.1.

revenue for the registered charities is received from government funding. Only approximately 8% of charities' revenue comes from individuals and 1% from corporations. Of the individual charitable donations, almost one-half go to places of worship. There is no reason to believe that the CRT would be any more target efficient than regular donations. Individual donors receive the same tax incentive irrespective of the charity chosen, and when given the choice of a plethora of possibilities, donors have not chosen to help the most needy in our society. Providing further tax incentives to donors will further reduce federal government revenues and encourage the federal government to further cut important social programs.

4. Who benefits from the CRT?

The use of CRTs in Canada in their current form versus the U.S.-style CRT could primarily affect three interests, namely, the donors, the charities and the Federal government. There is little question that if U.S.-style CRT rules are brought to Canada, then many wealthier taxpayers who are interested in avoiding capital gains taxes would benefit from such rules. It is more difficult to see how the charities and Federal government will benefit.

Advocates of the U.S.-style CRT argue that charities will benefit from the widespread use of CRTs in that donors will give more and that the CRT is more legally enforceable than a bequest in a will. The proponents of CRT argue that they will

³⁶ All statistics in this paragraph are from David Sharpe. "The Canadian Charitable Sector: An Empirical Overview". A paper prepared for "Charities: Between State and Market" Conference, Toronto, January 19, 1999.

promote larger gifts of capital than donors would otherwise be willing to give during their lifetime. If the issue is whether a charity would prefer a donation via a CRT, or no donation at all, then the charity would presumably prefer the CRT. If the issue is, rather, whether a charity would prefer an immediate donation or have to wait decades to realize any gain, then there are few charities, if given such a choice, who would prefer the CRT option. Many charities would have an intuitive concern that after many years, and all the paper shuffling, that the charity will receive nothing at the termination of the trust.

Bromley argues that a charity would prefer a donation of an asset by CRT compared to the insertion of a bequest in a will. Bromley maintains that "the attractiveness to the charity is that the gift is irrevocable and legally binding rather than just being a stated intention in a will subject to subsequent unilateral changes in donor/testator's wishes".³⁷ It is after all possible that the donor before death will change his will, that there will be no assets in the estate to satisfy the bequest, or that a "greedy" relative will try to upset the bequest. Under paragraph 2 of IT-226R the gift "must vest with the recipient organization" and "it must be evident that the recipient organization will eventually receive full ownership and possession of the property transferred." It would appear that the donor could not change the beneficiary of the remainder interest.³⁸ If the donor can change the beneficiary then there is no certainty of the gift taking place!

The U.S. CRT rules allow the settlor in the trust document to reserve the right to change the remainder charitable beneficiary and replace it with another qualifying

³⁷ Bromley, p. 56:16.

³⁸ Chouinard discusses the substitution of the charitable beneficiary in Canada and concludes that if the trust document allows a substitute then such a substitution should not be a problem as long as the substitute is a charity. See Chouinard, p. 10-11. I think

beneficiary.³⁹ As the donor can change the residual beneficiary, the CRT is no better than a bequest in a will and it seems worse. The charity will have given a tax receipt to the donor, may have invested considerable time in the administration of the trust, and then could lose the opportunity to receive the residual interest. The ability to change the residual beneficiary of the will provides the settlor with influence over the charity after the receipt is given; it can also result in the reasonable expectations of the charity being disappointed. This is another example of the frustration that a U.S.-style CRT can cause a charity. The only situation in which it would seem reasonable for a donor to change the residual beneficiary would be in the event that the original charity no longer exists.

It is difficult to know what the voluntary sector's actual opinion is with respect to CRTs. It is unlikely that many charities would have much to publicly say about CRTs at this point in time. They are currently not a particularly attractive mechanism, from a settlor's point of view, for making a donation and there is consequently little pressure on charities to use them. As long as the charity is not encouraged or cajoled into using CRTs, then there is no point in angering or alienating large donors and their professional advisors who are advocates of an expanded role for CRTs.

With respect to the CCRA and the Federal government, Bromley makes an interesting argument that they could in fact benefit from the US-style CRTs⁴⁰. He argues that under the U.S. rules when a donor gives the highly appreciated capital assets that are not earning much income to the CRT they are then usually converted into high income yielding properties. This income, when paid out to the income beneficiary, is taxable.

Chouinard is incorrect, and Bromley correct, with respect to this matter. The wording "the recipient organization" does not contemplate a substitute.

³⁹ Rev. Rul. 76-8, 1976-1 C.B. 179

Bromley argues that in the end, the Canadian government will receive more taxes and after the "short-term income benefit", the charity receives the remainder.

Bromley conveniently ignores that in many cases the Canadian government would receive only pennies on the dollar if one compares the loss of the potential capital gains tax to the income tax received by the CCRA. As one U.S. commentator noted "CRTs yield significant net financial benefits to your clients only when they are funded with near zero basis long term capital gain property that will be otherwise sold."⁴¹ Furthermore, Bromley's "short-term income benefit" can be as long as the last income beneficiary is alive, and if the income beneficiary is an infant this could be many decades.

The CCRA and the Canadian government have opposed the widespread use of CRTs and attempted to avoid providing any encouragement to those who wish to set up CRTs. Recently the CCRA ruled that if a donor transfers the Qualified Securities to the CRT, then the donor will not be entitled to the reduced capital gains inclusion rate as the CRT is not a registered charity.⁴² They are obviously concerned that if U.S.-style CRTs were introduced into Canada, then there would be a substantial reduction in government revenues. As well less capital gains taxes would be collected and there would be an increase in charitable receipts which would also reduce revenues from income taxes.

⁴⁰ Bromley, p. 56:19.

⁴¹ Hoisington, p. 317.

⁴² Kleinman, p. 13.1.

5. Is the CRT simple to administer and comply with?

The proponents of U.S.-style CRTs use various arguments to claim that the current IT-226R rules are "uncertain" and imperfect in various respects; consequently, these problems make the Canadian CRT problematic to comply with and difficult to create and administer. I will deal with the uncertainty argument first and the imperfections later.

A) Uncertainty

Bromley, Chouinard and Goodman highlight the supposed "uncertainty" surrounding the valuation of the CRT, which they believe deters the use of CRTs in Canada. The answer to the uncertainty is as suggested by Bromley and Chouinard is a detailed U.S.-style CRT regimen. Bromley argues that if the CCRA does not provide "satisfactory administrative solutions" then the government of Canada should pass detailed legislation dealing with CRTs similar to the U.S. Section 664.⁴³ Chouinard asserts that "If certainty and predictability in the application of the Act to charitable remainder trusts are to be attained, clearly defined rules in the form of legislation, rather than administrative rulings, will have to be developed."⁴⁴

I will analyze the supposed "uncertainty" by reviewing one example, namely, the valuation of assets donated to CRTs. The uncertainty with respect to valuations is often cited as the greatest deterrent to using CRTs in Canada. I believe that the "uncertainty" is

⁴³ Bromley, 56:29.

overstated by the proponents of the U.S. CRT rules, but as I will explain later sometimes some uncertainty can be beneficial. With respect to the valuation of the residual interest this subject is dealt with in paragraph 5 of IT-226R which states:

The method of valuing a residual interest in real property or an equitable interest in a trust, whether it be for the purpose of determining the amount of a charitable donation or other tax consequences, will vary according to the type of gift, other interests in the property or trust and the documentation providing for the gift. The general approach is to value the various interests taking into consideration the fair market value of the property itself, the current interest rates, the life expectancy of any life tenants, and any other factors relevant to the specific case. In the case of property other than real property, the longer the period before the ownership of the property is passed to the charity, the more difficult it is to establish its value.

Paragraph 6 further states that where the value of the residual or equitable interest "cannot reasonably be determined", no deduction or tax credit will be allowed.

Bromley criticizes paragraph 5 of IT-226R as "providing little guidance with the result that both charities and donors are very frustrated in knowing how to determine the size of charitable gift receipt that should be issued."⁴⁵ Chouinard states that actuarial value of the charitable deduction "are no different for Canadian and United States donors",⁴⁶ but she complains that in the U.S. the Treasury Department provides tables that determine the value of the gift depending on certain factors, and no such tables are provided here.

Kleinman also discusses valuations, but, instead of complaining about the lack of legislation, he simply states that as certain aspects are not legislated, "basic logic must be

⁴⁴ Chouinard, p. 12.

⁴⁵ Bromley, p. 56:16.

⁴⁶ Chouinard, p. 9.

used."⁴⁷ The most important factor in determining a life interest is the age of the donor and the mortality rates that can be found in Interpretation Bulletin IT-112R2.⁴⁸ Kleinman maintains that such tables are used by the CCRA with respect to charitable gift annuities and should be acceptable to the CCRA for CRTs. Then the next issue is the discount rate. Although one can use the CCRA's prescribed rate, he argues that the Bank of Canada investment rate for the period of time of the mortality would be a more accurate discount rate.⁴⁹ He notes that this formulation would probably be acceptable to the CCRA with respect to cash, or similar to cash, assets. Kleinman admits that with risky businesses or assets, for example a restaurant, it is difficult for the CCRA, or for that matter a valuator, to calculate a discount rate. These difficulties are compounded if the mortality rate is quite long. In some case a special discount rate may have to be calculated for particularly risky assets.

Bromley criticizes the CCRA for a 1995 CCRA technical interpretation which deals with the use of current interest rates in determining value.⁵⁰ There is also Regulation 4301 with states that the current interest rate in IT-226R is not necessarily the prescribed interest rate.⁵¹ Both of these pronouncements, even if one disagrees with them, are not particularly material to a valuation. As U.S. lawyer Paul Callister notes: "The size of the remainder interest depends upon the fair market value of the property transferred to the trust at the date of transfer, the age of the beneficiary of the income stream, the interest rate selected for the payments, *and, although a minor factor, the*

⁴⁷ Kleinman, p. 10.2.

⁴⁸ Interpretation Bulletin IT-112R2 "Annuities Purchased from Charitable Organizations"

⁴⁹ Kleinman, p. 10.2.

⁵⁰ Bromley, p. 56:16

prevailing interest rates at the time of the gift."⁵²(emphasis added) When a U.S. CRT can provide the income beneficiary with an income up to 50% of the fair market value of the CRT assets per year then it is not difficult to imagine that current interest rates can be of negligible importance in determining the value of the remainder interest.

The real problem is not with the CCRA's general principles for valuing remainder interests, but, as Bromley later states, that "In my experience, the present value of the remainder interest is almost always so low that if the donor was attracted to a charitable remainder trust primarily because of the tax receipt, the gift seldom was made."⁵³ In many particular fact situations the remainder interests that the charity would receive is so negligible that it is not surprising that the tax receipt is very low or nil. Taxpayers have always been left to make self-assessments under the Canadian system with respect to taxes owing, and the charities to value gifts made to them. If donors, and their advisors, attempt to set up CRTs that provide a significant benefit to the donor, with little or no benefit to the charity, then it is not surprising that they will fail.

B) Imperfections

Chouinard argues that IT-226R "does not contain a complete set of rules regarding the tax implications of such trusts". She makes suggestions for improving the Canadian CRT including more detailed rules to restrict high-risk investments.

⁵¹ Revenue Canada Technical Interpretation dated October 4, 1995, Document number 9428885 cited at Fremes, p. 12:37.

⁵² Paul D. Callister, "Charitable Remainder Trusts: An Overview". (1998) 51 *Tax Lawyer* 549 at p. 556.

⁵³ Bromley, p. 56:16.

Chouinard points out that IT-226R does not have any requirement restricting the ability of the trustees to invest in high-risk, high-income investments as would be caught under the U.S. 5% possibility of exhaustion test.⁵⁴ She maintains that the trustee could invest in such high-risk investments that would benefit the income beneficiary and perhaps leave the charity and government with nothing. This points to one of the problems of CRTs in general: donors and charitable beneficiaries of the CRT will have very different interests once the CRT is setup. The donor will want to maximize the cash flow from the CRT, while the charity would want to preserve the capital.

In the U.S., there are detailed statutory and regulatory rules dealing with almost all aspects of the CRT and they are widely abused, with charities often receiving no remainder interest. In Canada, the trustee investment rules as set out in the various provincial trustee's acts are quite conservative, and, therefore, the trustee has to invest as a reasonably prudent investor would invest, and, consider the interests of both the income and remainder beneficiaries. If the trust document allowed for such high-risk investments, then this would reduce the valuations of the remainder interest and, consequently, the tax receipt.

How can the far less detailed Canadian rules do a better job of preventing abuse? One explanation of this phenomenon could be the Coase Theorem. According to the Coase Theorem, rules encourage people to plan around them and to nullify their intended effects.⁵⁵ The Coase Theorem, when applied to tax problems, would proffer that if there

⁵⁴ Chouinard, p. 11-12.

⁵⁵ See Daniel B. Thornton, *Managerial Tax Planning: A Canadian Perspective*. 2nd Ed. Queens University: Kingston, Ontario. 1999, page 13 and his footnote 17 on page 13 which cites Ronald Coase, "The Problem of Social Cost" *Journal of Law and Economics* 3 (October 1960), pp. 1-44.

are no impediments to planning around the tax laws, then people would do so until they have no taxable income or the marginal costs of performing the tax avoidance is equal to the marginal gain. Impediments usually fall into the categories of transaction costs (legal and accounting fees, triggering of taxes), agency costs (people not trusting each other) or imperfect information. To the extent that there is some uncertainty with respect to the CRT this uncertainty increases the costs of using a CRT, and, therefore, reduces the benefits of the CRT. Furthermore a taxpayer who wishes to abuse the tax system is more likely to use a method that is more certain to result in his objective rather than one which is uncertain and can be easily upset by the CCRA. As neither the taxpayer nor the charity who enters into such a transaction fully trusts the other, so the legal and accounting fees to document and monitor the transaction, would be quite high.

The proponents of CRTs are ostensibly concerned with "certainty" and with improving the CRT but really they are more concerned with changing the rules dramatically to be more favourable to the donors as is found in the U.S. I believe that IT-226R, as currently constituted, strikes a reasonable balance between the needs of charities, donors and government.

6. Does the CRT systematically disadvantage some group of individuals?

The charitable tax credit in a progressive tax system favours those of who are wealthy and have significant income. The CRT is even worse in that the costs of creating and administering the CRT mean that it is only useful for taxpayers who can afford to give a very large charitable gift, ie. a minimum of \$75,000.00 -100,000.00 according to some

estimates. In Canada, where CRTs are not a standard transaction, the threshold is probably closer to \$250,000.00. Furthermore, it is only the more sophisticated charities or donors who would be able to make use of this technique. Additionally, it should be remembered that only settlors with a large income can use the large donation receipt to offset annual income⁵⁶ either in the year of the donation or within a five-year carryover period.⁵⁷

VII. The CRT's future in Canada

Recent budgetary changes that allowed donations of certain Qualified Securities at a lower capital gain inclusion rate will encourage donors to give larger charitable gifts. Furthermore, and perhaps most importantly, now that there is a way in Canada for an important category of appreciated assets to be donated to charity with less capital gains tax this will undercut those who favour U.S.-style CRTs in Canada. There are many ways to donate assets to a registered charity, but if a charitable tax receipt is to be issued then it needs to be relatively certain that the charity will in fact receive the gift; unfortunately, this is not the case with the U.S. CRT rules.

Currently, as Goodman, Chouinard and Bromley have complained, the Canadian CRTs offer little tax incentive but may be useful for those who have a charitable intention. I think it should be kept that way. If Canada adopts U.S.-style CRT rules, then Canada must be prepared for U.S.-style CRT abuse.

⁵⁶ Petroff, p. 10.

⁵⁷ See Gifts and Income Tax, Canada Customs and Revenue Agency P 113(E) Revised 1999, and Callister, p. 549

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