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Cross-Border Philanthropy: Obtaining a U.S. Income Tax Deduction for a Donation to a Canadian Charity

This article examines the applicability of the U.S.-Canada Income Tax Treaty, which carves out an exception permitting deductibility if the U.S. individual has Canadian source income, and, it will discuss options for using a U.S. charity for indirect cross-border philanthropy for individuals who do not have Canadian source income.

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While it's easy enough to make a charitable donation to a Canadian charity, finding a way to deduct the contribution for U.S. income tax purposes is a much more complicated endeavor. The default rule prohibits any deduction—a U.S. citizen or resident (referred to as U.S. individual in this article) may not claim a U.S. income tax charitable deduction for a donation to a foreign charity. But with some advance planning, a U.S. individual may be able to secure the desired U.S. income tax deduction in spite of the default rule. This article will examine the applicability of the U.S.-Canada Income Tax Treaty, which carves out an exception permitting deductibility if the U.S. individual has Canadian source income, and, it will discuss options for using a U.S. charity for indirect cross-border philanthropy for individuals who do not have Canadian source income.

The first roadblock that the U.S. individual must overcome on the road to deductibility is the same roadblock that applies to all taxpayers, regardless of whether their charitable giving is domestic or abroad. That is, to claim a charitable deduction, the taxpayer must generally itemize his or her deductions. With the exception of the special \$300 deduction allowed for tax years 2020 and 2021 (which is doubled to \$600 for joint filers for 2021), if an individual does not itemize, no charitable deduction will be allowed. In 2021, the standard deduction for a single individual is \$12,550. For individuals who are married and filing jointly, the standard deduction is \$25,100. A taxpayer whose itemized deductions do not exceed the applicable amount will claim the standard deduction, and the rest of the considerations in this article become moot.

Assuming that the U.S. individual intends to itemize their deductions, they must then turn to the



U.S.-Canada Income Tax Treaty to determine what relief the Treaty provides to the default rule prohibiting deductions for foreign charitable contributions. While the Treaty does provide some relief, it is incredibly limited in scope. Under the Treaty, a U.S. individual may claim a U.S. income tax deduction for contributions made to a Canadian charity, but (1) the deduction may only be claimed against the individual's Canadian source income, and (2) the adjusted gross income (AGI) percentage limitations that apply to domestic giving must also be applied against the individual's Canadian source income. The Treaty then creates an exception to the exception, and suspends the AGI

limitations for contributions to a college or university at which the U.S. individual or a member of his or her family is, or was, enrolled; even though the AGI limitations do not apply to this specific category of donations, these taxpayers must still have Canadian source income if they wish to claim a deduction for the donation to the Canadian university.

Assuming that the U.S. individual has Canadian source income, the next step in the convoluted road to determining deductibility is to ascertain which AGI limitation applies. A gift to a charity is generally deductible against the taxpayer's income, but there are certain AGI limitations. For 2020 and 2021, as part of the COVID-19 relief legislation, Congress raised the AGI limitation for cash gifts to 100% of the taxpayer's AGI if the gift is to a public charity. Prior to 2020, the deduction was limited to 60% of the taxpayer's AGI if the cash gift was to a public charity. A cash gift to a private foundation is still limited to 30% of the taxpayer's AGI. A gift of publicly traded stock (provided that the stock has been held for over a year and is long term capital gain property) to a public charity is also subject to a 30% AGI limitation; if the stock is contributed to a private foundation, the limitation is reduced to 20%. Excess deductions may generally be carried over for five years.

The phrases "public charity" and "private foundation" are U.S. legal concepts that are not utilized in the Canadian income tax regime. As such, the determination must be made under the U.S. rules. As a default, if the Canadian charity received a Notification of

Registration from the Canada Revenue Agency, the IRS will automatically recognize a Canadian charity as a §501(c)(3) charity taxed as a private foundation.

If the Canadian charity believes it would qualify as a §501(c)(3) public charity under the U.S. rules, and it wishes to be recognized as such (which would, among other things, allow U.S. donors to receive the larger AGI percentage limitation for deductions), it must apply to the IRS for public charity recognition. It may do so by filing a full blown Form 1023 Application for Recognition of Exemption. Or, the charity may use the short cut letter application that is available only for Canadian charities, the requirements for which are laid out in the Form 1023 instructions. If the Canadian charity has not taken either of these steps, it will be deemed to be a private foundation by the IRS, and the U.S. individual will be stuck with the lower AGI limitations applicable to donations to private foundations.

The Treaty relief may be useful for U.S. individuals who live in Canada and who therefore will likely have a good deal of Canadian source income. But the average U.S. individual living in the United States does not have significant amounts of Canadian source income, and therefore will be unable to claim a deduction for a contribution directly to the Canadian charity. The U.S. individual may seek out a U.S. organization which will in turn support the particular Canadian charity or mission of the Canadian charity. The three most likely options are "friends of" organizations, a donor advised fund, or a private foundation.

If the U.S. individual is lucky, he or she may be pleasantly surprised to discover that the Canadian charity has already created a U.S. "friends of" organization to facilitate U.S. charitable giving. The "friends of" organization is a U.S. public charity formed for the primary purpose of supporting a specific international organization. The U.S. individual may make contributions to the "friends of" organization and take a full charitable deduction against worldwide income, regardless of any sourcing rules (but still subject to the AGI limitations laid out above). The U.S. charity will then make grants, from time to time, to support the Canadian charity. But note that the U.S. "friends of" organization's board has total control and decision making authority over making distributions to the Canadian charity, and the U.S. donor may not ear-mark the donation to be directly distributed to the Canadian charity.

If a U.S. "friends of" organization does not already exist, the donor could approach the Canadian charity about forming the U.S. organization. But the costs of forming and maintaining the "friends of" organization only make sense if the Canadian charity has a broad base of support among U.S. donors who have committed to make significant, on-going charitable gifts.

If a "friends of" organization does not exist, the U.S. individual can consider making the contribution via a donor advised fund. Under this option, a U.S. taxpayer would create a donor advised fund at a U.S. public charity (the Sponsoring Organization). The donor advised fund would be identified as a segregated account at the Sponsoring

Organization, over which the donor would retain advisory privileges. Because the Sponsoring Organization is a U.S. public charity, the U.S. individual is credited with having made a donation to a U.S. public charity, and is entitled to a deduction against his or her worldwide income, subject to the AGI limitations applicable to gifts to public charities.

As the advisor to the fund, the donor may request that distributions be made from the donor's segregated fund to a Canadian charity. The Sponsoring Organization would conduct the due diligence to ensure that the potential Canadian charity is in fact a charity that is eligible to receive a charitable contribution from a U.S. public charity. Assuming the Canadian charity passes the due diligence requirements, the Sponsoring Organization will generally accept the request from the advisor and make the distribution to the Canadian charity. While any donor advised fund may make international grants, there are some Sponsoring Organizations that cater to international grant-making. The U.S. individual may wish to seek out one of the Sponsoring Organizations with international grant-making expertise, as the organization will be comfortable performing the due diligence on the Canadian organization and accepting the advisor's request to make the distribution.

Of course, many good things come with a cost, and the Sponsoring Organization will charge a fee for administering the donor advised fund, resulting in a smaller amount of the donation going towards the ultimate intended charitable purpose. Donors who

are considering the donor advised fund option must also be comfortable with the fact that the ability to direct a distribution to the intended charity is advisory only. In order for the donation to the Sponsoring Organization to be tax deductible, the donor may not retain the legal right to direct the activities of the Sponsoring Organization. Some donors may not be fully comfortable with the fact that their rights are advisory only, and in that case, a donor advised fund is not for them.

A final option to consider for the U.S. individual looking to engage in Canadian cross-border giving is the formation of the taxpayer's own private foundation. The U.S. individual would first make a contribution to the private foundation, entitling the individual to a charitable deduction against his or her worldwide income, subject to the AGI limitations applicable to gifts to private foundations. A private foundation may then make grants to foreign organizations, if certain due diligence requirements are fulfilled.

There are legal and accounting costs to form a private foundation and then to administer the private foundation on an ongoing basis. In addition, private foundations are subject to a unique set of rules and excise taxes that are intended to prevent self-dealing and other situations that are deemed to be abusive. In addition to the financial costs, the donor will also have to expend mental energy to learn and understand the private foundation rules. These costs mean that the private foundation option is best suited for individuals who are committed to large scale, multi-year grant making. If an individual is

looking to make a one-off contribution to a Canadian charity, the donor advised fund option will likely be a better fit, assuming a U.S. "friends of" organization is not available.

While the U.S.-Canada Income Tax Treaty does offer some relief for U.S. individuals seeking a charitable income tax deduction for a contribution to a Canadian charity, the relief is often of limited utility. Many U.S. taxpayers seeking to deduct a contribution to a Canadian charity will only be left with the option of donating to a U.S. charity that engages in international grant-making, which may result in additional costs and complications to the donation. However, if the contribution is large enough, the additional effort to secure the donation may be well worth it.

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