Strategic Giving: Where Technique and Product Knowledge Results in Transformational Giving While Benefiting Canadian Donors and Their Families

Session 2

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5. Gifts of Life Insurance

Life insurance is an important tool in the estate and gift planning process. The key to life insurance is that proceeds received due to death are tax-free. Because 100% of gifts are deductible on the final tax return and gifts left via a will are usable in the final tax return, interesting planning possibilities arise.

It is noted that the following examples in this chapter utilize simple insurance products. These examples are meant as a guide. When actually acquiring suitable product, more varied and diverse insurance product will be used in most cases.

New Life Insurance

For gifts of new life insurance, the income tax deduction relating to the creation of a policy is the amount of premium contributed for the purchase of the policy. A gift of $1,500 to Charity to pay for the premiums on a $100,000 policy will actually cost the donor $750, after tax (for a highest tax Ontario resident). The gift of life insurance enables the donor to leverage a relatively small contribution into a dramatically large gift.

WHO SHOULD USE THEM?

Gifts of life insurance are perfect for donors looking to make a bigger gift while spending the same amount of money. As part of an estate plan, assets gifted to an organization can be replaced with funds from a life insurance plan after death tax-free. It is particularly effective to combine insurance with a gift of private company shares, since the insurance will fund the redemption of the shares after death. Donors with existing policies should consider gifting them rather than canceling them, since there is value to old policies. Meanwhile, new insurance is extremely useful for a 50 – 70-year-old donor as part of an estate and giving plan.

Existing Life Insurance

The contribution of a paid-up policy or a policy that has been in effect for several years but which requires additional premiums entitles the donor to an immediate income tax deduction equal to the value of the policy. Often the value of this policy is greater than the cash surrender value. The charity should endeavor to determine the true market value of the policy to determine the gift and tax receipt issued. Under the ITA the proceeds of disposition is still the cash surrender value. Thus, you could get a large receipt and little corresponding income. This yields interesting planning.

Old policies that are no longer needed by the donor or donor's family can create current tax benefits. Often these policies, purchased originally to protect the spouse and young children and provide liquidity for the family, outlive their usefulness. After the children have grown and the protection for which the insurance was purchased has been provided by other assets, the insurance can be used to satisfy a charitable donation.

These matured policies may have the additional advantage of providing substantial cash values available to Charity. The cash in the policies and future dividends earned will often be sufficient to pay future premiums, without further contributions by the donor or cost to Charity. Alternatively, the cash can be withdrawn by Charity for its immediate use.

Giving life Insurance Proceeds at Death

One can purchase a life insurance policy and not have the policy owned by the charity. The premiums paid are effectively not deductible. The will can set out the gift of the insurance proceeds. Essentially, one is switching the tax deductions from the premiums paid during lifetime to the proceeds of the life insurance on the final tax return.

Corporate Applications

Even more beneficial is a corporate owned policy. The corporation pays the premiums. At death, it receives the insurance proceeds tax-free and pays it out to the Estate tax-free. (The children retain the cash and the gift is still made out of the will with appreciated securities.) Because the corporation pays the premiums it is poorer. Thus, the tax on death on the company shares is less (take a 26.5% discount on the effective cost of the premium). This simple gift-corporate insurance – will gift of securities often means the gift is made to the family without any net cost or at very low cost.

Direct Designations

Gifts of insurance proceeds made in a will result in a donation credit on the final tax return. For deaths occurring after 1998 the credit is available for gifts of policies made through direct beneficiary designations even if not in the will.

EXAMPLE

Scenario 1: *John's company purchases a $1,000,000 policy on his life. It pays premiums of $25,000 a year until age 100. In his will, John leaves $1,000,000 to Charity.*

Pros: On his final return John saves $530,000 of tax (53% of $1,000,000).

Cons: Johnco pays $25,000 a year, non-deductible. If it pays this for 20 years, the payments will total $500,000.

Net: It appears that John is ahead $30,000, but what about the time value of money?

Adjusted Scenario 1: *Assume John's mortality is 20 years and the interest rate is 3.0%.*

Adjusted Pros: Present value of the $530,000 of tax savings ($530,000 for 20 years at 3%) is $285,143 (I get a diff nb).

Adjusted Cons: Present value of $25,000 with payment for 20 years is $383,085. After tax, this cost is effectively $302,834.

Adjusted Net: It appears that the cost of creating a $1,000,000 gift is about $17,691 today.

Scenario 2: *The will gift gives the life insurance proceeds, but it could give appreciated securities instead, which are taxed in the final return. Assume $1,000,000 of securities with a $700,000 cost. The Estate Sales Taxon $300,000 of gain (53% x 50% of 300,000) is $79,500. The present value of $79,500 ($79,000 for 20 years at 3%) is $42,502 (I get a diff nb).*

New net: The new net cost of the $1,000,000 gift is about minus $24,811. The family is now ahead $24,811 in today's dollars.

Conclusion

The tax-free value of insurance allows for exciting Canadian-made gift planning. There are countless possibilities which the professional planner can take advantage of, including the purchase of mining donation shares to fund premium donations. Throughout this handbook various plans are explored using life insurance.

6. Retractable Donations

The term retractable is well known to Canadian professionals. It is used to describe certain preferred shares where the holder of the shares has the right to demand the redemption of the shares at any time.

The retractable donation is a donation that can be retracted at the volition of the donor. In the United States it is known as a lead-trust and sometimes in Canada as an interest-free loan.

Effectively, the donor makes a loan to Charity. As the loan can be retracted, the transfer of property is not irrevocable and therefore no charitable receipt will be issued. The income earned by the Charity from the loan proceeds can be used for charitable purposes at the direction of the donor. Annually the donor will not be taxed on the income; neither will he/she receive a tax receipt.

WHO SHOULD USE THEM?

Retractable donations are perfect for donors who wish to donate but are stopped by a sense of insecurity about the future. These donations are essentially loans that allow donors to support an organization, then take their money back when and if it is needed.

7. Charitable Remainder Trust

One can think of this gift as a reverse trust. Often a testator will leave a bequest, whereby the income will go to an individual (spouse, child, etc) for life and at death the capital goes to the charity. The reverse is the income going to the charity with the capital equally distributed to the beneficiaries.

For example: Mr. S. leaves in a will for life that of $1 million to be invested with the income to go to charity. $50,000 of capital will be distributed to his spouse for 20 years or as long as she is alive. She receives the amount tax-free. The income goes to the charity. Now the beneficiary receives tax-free capital rather than taxable income.

EXAMPLE

Mrs. Greenwood is a successful businesswoman. She earns a considerable annual salary and has accumulated significant capital which is invested conservatively. Mrs. Greenwood sees these funds as her nest egg. She, of course, pays tax at the highest level on the investment income earned. She wishes to build a fund for Charity but does not want her nest egg impaired for herself or her heirs.

Mrs. Greenwood loans Charity $1,000,000. Charity uses the income earned on the funds. If ever Mrs. Greenwood wishes to recover the $1,000,000 she demands repayment from the Charity.

Over time, as the donor is able, she may forgive the loan to Charity. The amount forgiven will be used to calculate the donation receipt. A forgiveness on death will yield a receipt usable on the donor's final tax return.

A Charitable Remainder Trust ("CRT") is a planned giving concept derived from the US. In Canada there is no such legal entity. Unlike the US, where the Internal Revenue Code contemplates the CRT in legal fashion, there is no such mention in the Canadian Income Tax Act. Under Canadian law, a CRT is a trust, plain and simple, and certainly not a charitable organization. How a Canadian is deemed to have made a gift to a charity when a transfer of property to a CRT is based on logic but more on old Interpretation Bulletin IT-226R, which deals with the transfers of residual interest to a charity.

The CRT is a trust which holds capital transferred by the settler or donor. Effectively, the trust will pay income to the donor or other named income beneficiary during his or her lifetime and then distribute the capital to the charity upon the death of the income beneficiary.

The Interpretation Bulletin IT-226R settled CRA's position as to what is a valid Charitable Remainder Trust. The most important requirement in relation to the establishment of the gift is that property is transferred to the trust irrevocably. In this way, no one can remove capital from the trust except the charity. The donor cannot have any right of encroachment. This type of trust is different from the typical spousal trust, which allows for the spouse to be an income beneficiary for life but also allows for capital encroachment during the spouse's lifetime.

WHO SHOULD USE THEM?

Charitable remainder trusts are perfect for donors who will leave more to charity upon death than they need from a tax perspective – often, donors with no children. The CRT creates a receipt that can be used during the donor's lifetime and reduce the ultimate receipt on death which would otherwise not be fully used. This creates a free gift!

What are the benefits to the donor of establishing a charitable remainder trust?

First and foremost, is the establishment of the gift during the lifetime which the donor knows will be available to the charity for its full use upon the donor's death. Next, an annual income flow will be realized by the donor or designated beneficiary. Usually the charity manages the investment of the CRT, but the investment could be managed by the donor's normal manager. The donor appreciates that a professional methodology of obtaining such an income flow is now being taken from his/her hands and placed in others, which may be capable of obtaining a higher return with relatively low risk. Moreover, the donor, depending upon the facts, may have the opportunity of receiving a donation receipt immediately upon transfer to the trust. Particularly with the movement of the donations limit to 75%, this could enable the donor to realize substantial tax savings today in relation to the disposition of property which effectively he/she will be living on the rest of his/her life. Lastly, costs of probate are avoided.

It is possible for the charity to have the CRT invested by the donor's broker, so that the investment of the donor can remain similar to before.

This also may ease its administration, though the charity still has administration. The charity starts to receive the income from the investments and pays it out to the donor. It should do an arrival tax return and T3 summons.

Realization for Tax Purposes

As a CRT is a normal trust like any other, any property transferred to the CRT will be deemed to be a disposition for tax purposes. This may result, depending on the value of the property and its adjusted cost base, ("ACB") in a capital gain or loss. Because the donor is maintaining an income right for life (and perhaps for a spouse) the disposition is not complete. In essence, what is transferred to the trust is the remainder value of the property and not the life interest of the property.

How does one determine what are the proceeds of disposition of the property or the value of the gift in order to calculate a donation receipt?

Legislation is not offered to determine the methodology for computing the gift, and thus basic logic must be used. As the donor is maintaining a life interest, the length of that life is very important in determining the value of the gift. Obviously, the older the donor, the fewer years in which income will be received by the donor and the sooner the charity will receive the gift for full use.

The discount rate is more difficult to determine. Should one use CRA's prescribed rate? Perhaps, but from an economic point of view this may not be quite accurate. Probably the best discount rate to use is the Bank of Canada investment rate for the period of time of mortality. What this means is, if mortality is two years, then the discount rate could be the Bank of Canada investment rate for two years. If mortality is thirty years, the Bank of Canada thirty-year investment rate could be utilized. This methodology is fair and probably would be accepted by CRA. CRA may have some difficulty in determining discount rates for property that is not cash or similar to cash, eg. Business assets.

EXAMPLE: Calculation of a CRT Gift

Assume the following:

- *$100,000 transfer*
- *Male donor, age 78*
- *A 13-year mortality*
- *Bank of Canada interest rate on a 13-year security is 3%*
- *$100,000 discounted at 3% for 13 years is $68,095*

Thus, a charitable donation receipt of $68,095 is received by the donor to be used immediately on the donor's tax return.

8. Gifts of Residual Value

How would one provide a discount rate for a restaurant, for example? One would argue that in determining the value of the restaurant one would, in essence, discount the value because of the type of asset and the risky nature of the restaurant industry. However, Revenue Canada might determine that if mortality is quite long and since the restaurant business is quite risky, then a special discount may have to be calculated. Thus, to calculate the proceeds of the disposition, take the full value of the property at the date of transfer to the trust and discount this value by an interest rate (discount) factor using mortality as the number of years in the calculation. The result would be the proceeds of the disposition and this amount would be the donation receipt for the donor.

To calculate the resulting capital gain or loss, what would be the adjusted cost base to be used? Presumably the asset would have a cost base which is known. If the value of the property is$100,000 and the gift or proceeds of disposition is determined to be $60,000, 60% of the actual value of the property, then one would apply 60% of the adjusted cost base as the cost base for the remainder interest of the property which has been transferred to the trust. The rest of the cost base would effectively be the cost base attached to the life interest which is being maintained in the trust.

Conclusion

The charitable remainder trust is an excellent charitable giving tool. The options available are many. The trust can choose to invest with the Charity's other assets. The trust can invest on its own and follow the investment policies of the donor. The assets transferred can vary. They can be cash, marketable securities, real estate, or even a business. The CRT set up in a will does not, due to a technical anomaly, create a tax receipt on death.

Very similar to the Charitable Remainder Trust**,** the gift of a residual interest contemplates the transfer of an asset, not necessarily to a trust governed by the charity, but directly to the charity. In this case, there will be no income allocated during the lifetime of the donor, but instead the use of the asset will be available to the donor and perhaps other members of the family for life. For example, if a donor wishes to transfer his principal residence to the Charity, he could do so as a gift of residual interest. The use of the home for the rest of his and his spouse's life will be kept by the donor. On the death of the donor and the spouse, the charity will then have the full use of the house presumably to be sold at that time for cash.

The reason the donor would enter into a residual interest gift (besides the act of charity), is to receive a donation receipt immediately, even though the actual use of the asset will be available for life.

Like the calculation of the donation receipt for the CRT, one would examine, at the date the gift is made, the value of the property transferred, the mortality of the users of the property, and a discount rate based on market interest rates at that time.

There is a deemed disposition for tax purposes. Also, identical to the CRT, it is not the complete asset which has been disposed of, but just the residual or terminating interest of the property. The life interest in the property has been retained.

WHO SHOULD USE THEM?

Gifts of residual value are perfect for donors who will leave more to charity upon death than they need from a tax perspective – often, donors with no children. Like a charitable remainder trust, gifts of residual value create a receipt that can be used during the donor's lifetime.

The calculations in determining the proceeds of disposition and allocation of cost base are identical to that found for CRTs. Again, the taxation of this gift mechanism is governed by old Interpretation Bulletin IT- 226R.

What is key to this gift, again like CRTs, is that the gift must be transferred irrevocably to the charity to issue a charitable donation receipt to the donor.

There are very few types of assets where gifts of residual property would occur. Typically, we are talking about personal use assets such as a principal residence or artwork. From a tax point of view, the principal residence residual gift transfer can make a lot of sense, given the fact that usually there is no need to recognize the capital gain on the deemed disposition of the residual interest. The reason for this is the special exemption from capital gains tax for properties which are principal residences.

If this is the case for the donor, then the transfer to the charity will not result in a taxable capital gain but the receipt would still be calculated in the normal manner and thus the opportunity for substantial immediate tax savings would occur.

EXAMPLE

Mrs. Schwartz, a widow, age 82 has decided to leave her condominium to Charity. The condo is valued at $350,000; the original cost was $200,000.

Assume the following:

Condo is a principal residence for length of ownership.

Mortality	*11 years*
Discount rate	*3%*
Value of condo	*$350,000*
Present value of gift or residual value	*$252,847*

Mrs. Schwartz will continue to live in the condo or a replacement residence for her lifetime. She will pay all associated property taxes, insurance, maintenance costs.

In the case of a principal residence transaction, the charity would want to ensure that if the donor and the spouse are going to use the property, that the donor contract to pay all costs in relation to the upkeep of the home. These would include the property and school taxes, insurance costs, maintenance costs and other costs associated with maintaining the home. The nature of the gift would be set out in a deed of gift evidencing the transfer of the property to the charity, evidencing the right of the donor and other specified individuals to use the properties for their lifetime and setting out the donor's responsibility for the costs of the upkeep of the home. It is noted that the gift provision could indicate that if the donor is still alive, he/she may have the right to have the house sold by the charity and replaced with another home to the extent of the proceeds received from the sale of the first residence. The donor would continue to live in the second residence for his/her lifetime.

This type of gift can be achieved for other properties, e.g., artwork. The legal title to the artwork would be transferred to the charity, but the right of use for lifetime would be kept by the donor. In this case, the donor would be responsible for the maintenance and insurance costs. The value of the gift would be calculated in the same manner as above. However, due to the fact that artwork is taxable, any gain realized due to the residual transfer of the artwork would be taxable to the donor.

9. Gifts of Capital Property

There are two components to a gift of capital property. The first is to determine the value of the property for the purposes of issuing a charitable receipt. The second is that one is deemed to have disposed of the capital property for proceeds equal to the value of the property.

This deemed disposition provision obviously will not have any effect where the cost base of the property equals the value. When this is not the case, the possibility of a capital gain arises.

Fifty per cent of the capital gain is taxable. There are effectively two ways to offset the taxable capital gain, the first being to utilize the tax receipt against that income, the second via an election.

As discussed in the section on percentage limitations, the Income Tax Act does allow the donor to use the receipt to the extent of 75% of income created or 75% of any taxable capital gain created, plus an extra 25% of the taxable capital gain created on the transfer of property to the charity. Thus, 100% of the taxable income will be offset by the donation credit in the case of individuals or the donation deduction in the case of corporations.

WHO SHOULD USE THEM?

Gifts of corporate capital property create capital gain, but also create a capital dividend account. They represent, then, a way to reduce the value of the company for estate tax purposes.

Election

A method to avoid the capital gain on disposition is an election available under the Income Tax Act. Subsection 110.1(3) of the Act for corporations and subsection 118.1(6) of the Act for individuals allow the donor to elect his proceeds of disposition for purposes of calculating the capital gain on the deemed disposition to be anywhere between the original cost of the property gifted and its fair market value. This had real value when the donation limits were only 20% without a bonus for capital gains realized on the disposition of the property to a charity. In these cases, it was very possible that the income added to a tax return could have been far greater than the donation receipt usable in the year. On a cash basis, taxes were paid in the year of the gift. With the new donation limits this situation should not occur.

There is no prescribed form for the election, which must appear in the donor's tax return in the year of the gift. An example - "Pursuant to Subsection 118.1(6) of the Income Tax Act (110.1(3) if the election is made by a corporation) I hereby elect that my deemed proceeds on the transfer of property to ABC Charity be ." Note that the charity will issue the receipt based on the full value. Only the elected amount will be used to calculate the donation credit or deduction

Capital Property in the Hands of the Charity

The new donation limit rules will, in some cases, make it preferable to donate capital property to the charity rather than selling the property, and donating the cash. The reason is the additional 25% of taxable capital gain donation limit. The donor should ensure, however, that the charity is capable of disposing of the property to receive the proper amount of proceeds. Often, the charity does not have the staff available and knowledge enough to deal with all aspects of the sale. The donor should help the charity with the disposition to ensure that the ultimate gift is as high as possible.

Subsection 69(II)

When a donor transfers appreciated capital property to a charity, he/she might elect, under the provisions of subsection 110.1(3) or 118.1(6) to reduce the proceeds of disposition.

Subsection 69(11) of the Act requires that where a taxpayer is taking advantage of a tax rollover to transfer property lower than at fair market value to a tax-exempt entity, then it is necessary for that entity to hold on to the property for a three-year holding period.

If the property is sold within the three-year period, then the presumed capital gain that was not realized by the donor or taxpayer on the original transaction would be realized at that time. This provision, subsection 69(11) could, on a technical basis apply to transactions where donors have elected for lower proceeds on disposition, due to the fact that a charity is a tax-exempt entity.

In discussions with the Office of the Minister of Finance, they indicated that they will not apply subsection 69(II) to a transfer of capital property where the II8.I(6) election has been made, unless they feel that the objective of the donation was not bona fide. This would be the case where property is transferred to a charity, an election to lower proceeds upon disposition occurs, and then the charity disposes the property back to the donor or to an entity which he/she controls.

Another situation where subsection 69(II) might apply is where property is transferred to the charity and then the charity rents out the property to the donor or an associated entity. If one is planning a substantial transaction where the election will be used, one should check with CRA to ensure that subsection 69(II) is not applicable.

EXAMPLE

Mrs. Jann transfers capital property (land) to Charity. The original cost of the land was $80,000; the value today is $200,000. Mrs. Jann has an allowable capital loss carry forward available of $60,000.

Proceeds	*$200,000*
Cost	*80,000*
Capital Gain	*$120,000*
Taxable Capital Gain	*$60,000*
Utilization of Loss Carry forward	*(60,000)*
Taxable Income	*0*

Use of the Charitable Receipt

75% of net gain (75% of 60,000)	*$45,500*
25% of Taxable Capital Gain	*15,000*
	$60,000
Receipt Received	*$200,000*
Receipt Carried Forward	*$140,000*

**Note: If Mrs. Jann has no other income she would probably choose not to use the majority of the receipt. A charitable tax credit cannot create a tax refund; it can only reduce taxes payable to nil.*

Tax Shelter Legislation

Subsection 248(35) was enacted to counteract donation tax shelter schemes where property was purchased at a value and then donated at a much higher value. It unfortunately is broad enough to catch some donations without such intentions.

If a donation of property is made, subject to exceptions, if the property was purchased within three years of gift, or within ten years if one of the main intentions at purchase was to donate it, then the donation receipt to be used will be limited to the lower of cost of the property or its fair value at the time of gift.

Luckily there are exceptions, including listed securities, inventory, ecological land, and Canadian Cultural Property. What about private company shares and real estate? There is only partial relief. Gifts of real estate located in Canada are exempt; but foreign real estate is not. Gifts of private company shares are exempt, but only if the donor or a related group controls the corporation.

Capital Dividend Account

If it is a Canadian corporation which has made a gift of capital property and a capital gain is realized, a portion of the capital gain is not taxed. If 50% of a gain is taxable then 50% is not taxed. (In the case of a gift of public company shares 100% is not taxed.)

The amount not taxed enters the corporation's Capital Dividend Account. Dividends paid out of the Capital Dividend Account are received tax-free by the shareholders. Thus, a corporate gift of property can result in a taxable capital gain but also a Capital Dividend Account, which is very valuable.

10. Gifts of Marketable Securities

The Federal Budget of February 18, 1997 created a new incentive for the gifting of marketable securities to charities. The provision acts to eliminate the inclusion for tax purposes of income realized by virtue of the disposition. For example, if a donor transfers shares of TD Bank to a charity, a tax receipt equal to the value of the TD shares is issued. If the normal capital gain would be $80 given a value of $100 and a cost basis of $20, normally half of the $80 or $40 would be taxable. Under the new provision zero would be brought into income. The provision is limited to securities listed on prescribed stock exchanges, which includes all of the Canadian stock exchanges, as well as stock exchanges in the U.S. and elsewhere. Mutual funds based on public securities are eligible. Flow- Through mining shares as of 2012 are not eligible. (The capital gain in Quebec may be eliminated if it is a strategic investment). The complete gain not taxed (100% of the gain) goes into a Corporation Capital Dividends Account.

WHO SHOULD USE THEM?

Gifts of marketable securities can be useful for any individual. They are also particularly effective for reducing the value of corporations who face state taxation. The corporation's value is reduced by the gift and the capital dividend account created also reduces the value of the company. A great tool to reduce estate tax!

How to Transfer Marketable Securities

Generally, investors hold marketable securities in two forms. Either they have securities in their name, or they own the securities via a broker without the security certificate in their particular name. To gift a security certificate with the donor's name, the donor would endorse the security certificate and transfer it to the charity. Usually a local confirmation of the signature is required. A donation receipt will be issued for the value of the security at the date of the gift.

Most of the time, the securities are held in a brokerage account and therefore there is no need to transfer the actual certificates. In this case the donor would direct his/her broker to transfer the securities into a new account in the name of Charity. The receipt will be issued based on the value of the securities transferred at closing. To set up an account in the name of Charity the broker will probably have Charity authorize the creation of the account.

Refer to the section on *Charitable Remainder Trusts* for an examination of using a trust to transfer marketable securities or other capital property to a charity in order to enhance current income of the donor. It is important to note that transferring marketable securities to a CRT will not be eligible for the reduced inclusion rate as a CRT is not a charitable organization, even if the charity is a trustee under the CRT.

EXAMPLE

Mr. Liu donates $100,000 of Royal Bank stock to McGill University. His original cost is $50,000. His alternative is to sell the stock himself and donate $100,000.

	Stock Donation	***Stock Sale***
Proceeds	*$100,000*	*$100,000*
Cost	*50,000*	*50,000*
Capital gain	*$50,000*	*$ 50,000*
Taxable capital gain	*$25,000*	*$ 25,000*
Special exemption	*(25,000)*	
Net income	*$0*	*$25,000*
Taxes payable 48%)	*$0*	*$12,000*
Tax receipt	*$100,000*	*$100,000*
Tax savings	*$48,000*	*$48,000*
Net tax savings	***$ 48,000***	***$36,000***

Partnership Interests

Beware the gift of a partnership interest which is capital property. For example, a limited partner in a real estate partnership may choose to donate his interest in the partnership and realize a capital gain on the transfer. His intention is to avoid recapture on a sale within the partnership. Unfortunately, section 100 will add income to the capital gain negating the plan.

Non-Qualifying Security

The Income Tax Act sets out a new methodology of taxation of gifts of private company shares and debt in circumstances where a "non-qualifying security" is gifted. The Act defines a non-qualifying security as an obligation of the individual (or a person not at arm's length with the individual), a share issued by a corporation with which the individual does not deal at arm's length or any other security issued by the individual or non-arm's length person. Specifically exempted are obligations, shares and other securities listed on prescribed stock exchanges and deposits of financial institutions. Thus, a gift of private company shares where the donor or member of his immediate family - parent, spouse, or child - controls, or as a group controls that corporation, would be considered a gift of a non-qualifying security. However, even many of these gifts will be exempted from the new rules.

Excepted Gift

An excepted gift is a gift of a share to an arm's length charity that is not a private foundation. The donor must be at arm's length with the directors and officers of the charitable organization or public foundation to which the gift has been made. Therefore, a gift to a public charity will be considered an excepted gift as long as the donor is not an officer or a director of that charity or if that donor is the parent, spouse or child of a director or officer of the charity.

Most gifts of private company shares to public charities should not be affected by the new rules unless this non- arm's length provision comes into play. It would be necessary for a donor to resign from the board of the recipient organization prior to making the gift. Since it is often the volunteers of a charity who feel most passionate about donating, this can cause problems.

WHO SHOULD USE THEM?

Because these shares are taxable at death, they make extremely tax-effective gifts in the will of any donor who holds them and greatly reduce estate tax liability. They are also excellent for donors looking to offset tax on an anticipated large transaction. Redeeming preferred shares can result in an immediate tax saving, avoiding capital gain tax at death and receiving a dividend refund. Gifts of private company shares are perfect for elderly donors who have built up refundable dividend tax on hand.

11. Gifts of Private Company Shares and Debt

Gift of a Non-qualifying Security

If such a gift is made to a private foundation or, in some cases, to a non-arm's length public charity, then the gift will be ignored for the purpose of the charitable donation tax credit. This doesn't mean that the disposition for tax purpose hasn't occurred because it will have. If the charity disposes of the security within five years or if the security ceases to be a non-qualifying security of the individual in the five-year period, the individual will be treated as having made a gift at that later time. The disposition of the security could occur by the corporation redeeming the gift or buying back the shares from the charity for cash. For example, if the gift was 100 preferred shares worth $1 million and three years after the gift, the corporation redeems those shares for $1 million, and then the charity has disposed of the security. If instead, a donor "sells out" so that he is no longer at arm's length with the company, then the shares owned by the charity at that point would no longer be non-qualifying securities and, therefore, the donor would be deemed to have made the gift at that time.

The gift made at that later time will be deemed for purposes of the charitable donation receipt to be the lesser of two amounts - (1) the fair market value of the gift at the original transfer and (2) the fair market value of the shares at the time when the securities are no longer non-qualifying.

Reserve Mechanism

What appears as quite onerous rules are not quite so bad. First, when the original gift is made and perhaps a capital gain is realized, the taxpayer will be entitled to take a reserve against that capital gain. In essence, the reserve will continue to be taken on a year-in, year-out basis until, within the subsequent five year period, the gift will be deemed to be made because of a disposition of the non-qualifying security by the charity. Thus, if in year three, the security has been disposed of by the charity, the donor will be deemed to have made the gift in that year. The original capital gain, reserved for the first two years, would be effectively taxable in year three as no reserve would be allowed then. However, the donation receipt would be available in year three to shelter the capital gain.

Of course, one only has five years to dispose of the security and thus, it is possible that the gift will never be deemed to have occurred. Even in this case, the charitable tax consequence of having the taxable income, due to the disposition, realized without an offsetting tax receipt, will still not occur.

Once the five-year period is up, under the new reserve mechanism it would no longer be necessary to bring the reserved deduction back into income in year six. Thus, in essence, the capital gain would fall off the table never taxed just as the donor will never receive a tax receipt for the gift of shares.

Death

If within the five-year holding period, the taxpayer dies and the actual disposition of the non-qualifying security takes place after death, then it would appear that the realization of the gift will occur without the possibility of the deceased being able to use it on a tax return.

As a result, this special provision has been enacted which will treat the subsequently resulting gift as having being made by the individual in the year of death rather than at the actual time of the disposition of the non-qualifying security.

Elections

The Income Tax Act allows a taxpayer to elect that his proceeds of disposition could equal an amount somewhere between his cost base of capital property gifted and the fair market value. This election is still available for gifts of non-qualifying securities and could be made either at the time of the original gift or at the time of the disposition of the non-qualifying security. Particularly in the Province of Quebec this election is key for Quebec tax purposes due to the lower donation limits but it may be that in estate planning situations where low-cost base shares are gifted to a private or public charity and there is no intention that the non - qualifying security be cashed in the foreseeable future that one would could elect out of the situation completely.

Loan backs

There is particular legislation dealing with loan backs. First, it is noted from the above review that a non- arm's length debt of a corporation is considered to be a non-qualifying security and an excepted gift does not include such a gift to a public or private charity. Thus, a gift of debt would be subject to the new rules and thus, the only way to receive a tax receipt would be if within the five-year period the debt would be redeemed for cash. Loan back legislation comes into play when an individual makes a cash gift and separately the charity holds a non-qualifying security of the individual within five years thereafter, and the charity acquired the security no earlier than five years before the gift was made. In this case, the gift of the individual will be reduced in value by the amount of the acquisition of the non-qualifying security.