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

Session 3

Robert Kleinman, FCPA, FCA

11. Gifts of Private Company Shares and Debt

Gifting Non-Qualifying Securities to Private Foundations

The gifting to private foundations is not quite as liberal as it is for public institutions. A gift of a non- qualifying security itself does not result in an adverse tax result immediately or in the future due to the reserve mechanism. One may elect pursuant to Subsection 118.1(6), to ensure proceeds of disposition will not result in a capital gain. What is lost is the extra ability to use a donation receipt in excess of the taxable capital gain realized on the transaction.

In the case of low-cost base shares where effectively 50% of the value of the gift would be converted into a taxable capital gain, the loss would be the fact that 100% of the value of the shares would be subject to a receipt and, therefore, there would be a 50% loss in terms of extra credit available.

In an estate planning situation with low cost base shares, the ability to roll these shares either *inter vivos* or via will to the private foundation without adverse tax treatment, appears to be still quite beneficial.

High Cost Base Shares

With shares to be gifted with a high cost base normally one would expect that a full receipt would be useable by the donor and the resulting capital gain would be either non-existent or quite minor. In this case, the donor would expect significant tax savings.

If these shares are non-qualifying securities, a receipt would not be issued unless the shares were disposed of within five year after the gift. It is in this particular case that the gift to private foundations would be limiting.

These new shares are high cost base shares, albeit with low paid-up-capital. This low paid-up-capital would mean that on redemption of the shares, although no capital gain would arise due to the high cost base, a taxable dividend would result. Therefore, these shares typically sit on the balance sheets.

If an individual gives these shares to a public or private charity followed by redemption of the shares he/she may have reduced the cost of the donation significantly.

EXAMPLE

If Mr. Sato gifts 50,000 preferred shares, worth $50,000, to a charity, and the company subsequently redeems the shares for $50,000, the following will occur:

Assuming a $50,000 cost base and a nil paid-up- capital Mr. Sato will receive a $50,000 charitable receipt which will save him $20,000 of tax.

Mr. Sato is $20,000 richer as is the company which is remitting $50,000 to the charity via the redemption of shares.

Due to the low paid-up-capital, the redemption will result in a dividend to the charity. The charity, of course, is exempt from taxation on its income. The dividend, however, is considered real to the payer corporation and it may be eligible for a dividend refund. (Note that if one of the main objectives of atransaction with a tax- exempt charity is to obtain a dividend refund, CRA has the right not to pay the refund. Beware of transactions where large dividend refunds are expected.)

In summary, the corporation has paid $50,000 and the shareholder has received $20,000. Normally, via a dividend, the corporation would spend $36,900 for the shareholder to retain $24,000 after the payment of personal tax on the $36,900 dividend.

Thus, for only an additional corporate cost of $13,100 a donation of $50,000 has been achieved. The "cost" of the donation is 26.2%. If a dividend refund is received on a dividend, then the cash outflow on the gift is nil.

Estate Planning

The advent of these rules does confirm numerous estate planning possibilities which could occur regarding the ownership of private company shares.

Consider: an estate freeze has occurred in which the second generation will receive common shares, leaving the first generation with preferred shares of the company. Twenty years has passed and now the value of the new common shares is considerable and the holders of the preferred shares, the parents, are aged. If the company was worth $5 million at the time of the estate freeze, perhaps now the company is worth $15 million with the common shares owned by the second generation worth $10 million and the preferred shares $5 million. One of the parents has passed away and transferred the preferred shares to the surviving spouse.

Conclusion

The gifting of private company shares (but not debt) is viable. Even if it is not a perfect system, this should be a major area for development in the near future. What is clear is that the parameters surrounding a gift of shares is much more complicated than other gifts. It is cautioned that proper legal and accounting advice be sought from both the point of view of the donor and the charity when these gifts are affected.

For example: Corporation A has realized $1 million of taxable income and wishes to eliminate the tax on this income. It purchases $1 million of preferred shares of Corporation B, another company in the group. Subsequently, it gives the share of B to a public charity. The charity issues a $1 million receipt to A (assuming a valuation has confirmed the value.) If, for example, the preferred shares are 3.5% cumulative, Corporation B would remit a $35,000 annual dividend to the charity (the dividends is not taxable to the charity, but are considered "taxable dividends"). The numbers here work very well to create tax effective philanthropy.

12. Gifts of Real Estate

Generally, an outright gift of real property to a public charity entitles the donor to a charitable contribution deduction or credit equal to the fair market value of the property. There are estate-planning possibilities in the transfer of real estate to a charity and these possibilities are examined in the chapter on individual estate planning. For the most part, what makes the gifting of real property a little more complicated is the special tax effects.

There are no special tax incentives for gifting real estate. Thus, there is typically no difference whether one gifts real estate or sells the real estate and gifts the cash.

There are two tax aspects upon the sale or gifting of real estate. The first is the calculation of capital gain on the property whereby the proceeds upon disposition or the deemed proceeds of disposition upon the gift will be compared to the original cost of property or of the land to determine if there is a taxable gain realized.

EXAMPLE

Mr. Cho wishes to donate an apartment building to Charity. The building was purchased in 1975 for $300,000. $270,000 is allocated to the building and $30,000 to the land.

Today the value of the building is $1,000,000, of which 20% is allocated to land. The undepreciated capital cost (UCC) of the building is $50,000.

Charitable Gift Receipt: $1,000,000

Tax Effects

	Land	Building	Taxable Income
Disposition	$200,000	$800,000	
Original Cost	$30,000	$270,000	
Capital Gains	$170,000	$530,000	$700,000
Original Cost		$270,000	x 50%
UCC		$50,000	$350,000
Recapture		$220,000	$220,000
Total Taxable income			$570,000

Donation Limits

Charitable Gift Receipt	$1,000,000
75% of income (.75 x $570,000)	$427,000
25% of capital gain (.25 x $350,000)	$87,000
25% of recapture (.25 x 220,000)	$55,000
Receipt Used	$570,000
Available for Carry Forward	$430,000

The second part, which is a bit more complicated, is that during its time treated as a business asset, depreciable property is depreciated (capital cost allowance is taken on it) in order to reduce annual net income from the property. Thus, on an annual basis, the original capital cost of depreciable property is reduced by capital cost allowance and every year a new undepreciated capital cost is formed. Upon sale, death, or gifting of the property any capital cost allowance which was taken is reversed, if the proceeds of the disposition are greater than the undepreciated capital cost at the time of the tax transaction.

For example, if a building which originally cost $100,000 was depreciated so that its undepreciated capital cost was $60,000 and if the sale or gift is valued at $120,000, there would be two separate tax transactions. The first is to compare the proceeds to the original cost of the building, $100,000. A $20,000 capital gain would be the realized. The next would be to take the original cost – $100,000 – and compare that to undepreciated capital cost of $60,000; $40,000 of recapture will be realized. Whereas 50% of capital gains are taxed, 100% of recapture is taxable. For Federal purposes a donation receipt can be used to offset all capital gains and all recaptured depreciation.

13. Gifts of Art

There are two distinct tax mechanisms for gifts of art. One involves a gift of Canadian cultural property which is governed by The Import Act of Canada. Where these art pieces are donated the gift will not result in a disposition for tax purposes and therefore, no capital gain will be realized. The donation receipt at value is useable against 100% of income. Unused receipts can be carried forward ten years, rather than the normal five.

Most art donations made to non-museums would not be subject to the Import Act and would be subject to the normal disposition rules for capital property. Thus, capital gains will arise on disposition and a full donation receipt will be received for the value of the art. Bona fide appraisals must be done in order to issue a proper donation receipt. It is noted that, unless part of a business, art is considered personal use property for the purposes of the Income Tax Act. This means that although capital gains will still be taxable, capital losses arising from the disposition of personal use property cannot be applied against other capital gains, only against capital gains arising from personal use property.

WHO SHOULD USE THEM?

Donors of art should be aware that obtaining Canadian Cultural Property Status will result in the best tax treatment.

Another rule which one may take advantage of is that personal property, regardless of the cost or fair market value, is deemed to have proceeds of a minimum of $1,000 and a minimum cost base of $1,000. Therefore, a gift of art that is valued at $1,200 which costs $500 would be deemed to have a cost base of $1,000 and a $200 capital gain would result.

Some taxpayers own vast collections with numerous pieces of art e.g. etchings, where the value of each piece is not great, but the value of the entire collection is substantial because of the numerous pieces. Using this deemed $1,000 adjusted cost base can create a situation where no or very little capital gain is realized but the donation receipt received is based on the value of the property.

EXAMPLE

Ms. Agarwal wishes to give five pieces of art to Charity. Values and original costs are described below.

Artwork	***Value***	***Cost***	***Deemed Proceeds***	***Deemed Cost***	***Capital Gain***
#1	*$3,000*	*$2,000*	*$3,000*	*$2,000*	*$1,000*
#2	*$4,000*	*$500*	*$4,000*	*$1,000*	*$3,000*
#3	*$800*	*$900*	*$1,000*	*$1,000*	
#4	*$900*	*$100*	*$1,000*	*$1,000*	
#5	*$500*	*$100*	*$1,000*	*$1,000*	
	$9,200				*$4,000*

Charitable receipt:	*$9,200*
Taxable capital gain (50% x $4,000):	*$2,000*

Note that although deemed proceeds are a minimum of $1,000 for personal use property, if the value of the property is only $600, the donation receipt will only be $600. However, the $1,000 deemed ACB and deemed proceeds of disposition will not apply for property acquired after February 27, 2000, as part of an arrangement in which the property is donated as a charitable gift.

14. Individual Estate Planning

Canada does not levy succession duties. However, its Income Tax Act does provide for deemed dispositions on death of the individual's assets. Taxation on deemed disposition is left for the second death. There is a tax rollover for assets left for the spouse. Disposition is particularly onerous for those who hold real estate as not only taxable capital gains will be realized but also recaptured depreciation.

Further, the value of RRSP's not yet matured or RRIF's will be brought into the tax return on death which can also result in an onerous tax. Please refer to the chapter on RRSP Gift Planning.

There are two major factors which contribute to the merger of gift planning and estate planning. The first is that the Income Tax Act provides for a donation limit of 100% on death. Donations can be utilized to offset 100% of the income on the final tax return which is dated at the date of death and 100% of the income realized in the year prior to death.

The second factor is that estates can make donations after death which can be moved into the final tax return of the deceased and therefore reduce or eliminate the taxes payable at death.

Wealth Replacement Life Insurance

The insurance technique can be worked in reverse. If appreciated assets are owned which do not need to be maintained in the family the asset can be gifted to the Charity pursuant to the will. Insurance can be purchased to replace the asset for the benefit of the family.

Utilizing the Corporation

If insurance is to be used to fund a gift to the community or to replace other wealth gifted by the family, the corporation may be the best place to hold and own the insurance policy.

EXAMPLE

Mr. and Mrs. Wilmot own a vacation condominium (acting as a second residence) valued at $500,000. Its original cost was $100,000. They have three children; none of whom would like to keep the property. They prefer cash.

In their will, on a last-to-die basis, the Wilmots bequeath the property to Charity. The Wilmots purchase a last-to-die insurance policy for a face value of $500,000.

On death the gift receipt issued by the Charity will more than offset the taxable capital gain realized upon death. In fact, the excess receipt can reduce other taxes payable.

The estate - and therefore the children -will receive $500,000 of cash, free of tax. Again, the family will receive greater after-tax proceeds and a terrific gift for the Charity has been realized.

Insurance proceeds on death are received tax-free by the corporation but are not included in the value for deemed disposition purposes on death of the shares of the company. Upon receipt, the insurance proceeds can be flowed-through to the beneficiaries tax-free via the capital dividend account, created by virtue of the insurance proceeds. An examination of corporate and estate planning techniques is found in the chapter under that name.

Summary

The objective of combining estate and gift planning is to recognize the potential for tax, and using gift planning to reduce the tax bill while making a gift. The planning will only work with charitable intent. One can replace tax liability with donations, but in the end the gift will reduce family wealth, even if the "cost" of the gift is reduced by the planning.

Corporate Shares

The shares of private corporations remain one of the largest potential causes for capital gains estate taxes. Further in this chapter we will examine methods to reduce the value of these shares.

Alternatively, in some situations we might consider an outright gift of the shares. For estate planning purposes one might consider the gift of preferred shares with a low-cost base in order to avoid the death tax on the shares. This topic is described in the chapter on *Gifts of Private Company Shares and Debt.*

The Private Company

The ability to pay tax-free intercorporate dividends, the tax deferral and the corporate limited liability have led to the frequent use of private companies in Canada. Owners of operating companies (OPCOS) wishing to protect excess earnings transfer the ownership of their shares in OPCOS to newly incorporated companies which became the parent companies of the OPCOS.

These holding companies (HOLDCOS) receive tax-free dividends from the OPCOS. The movement of wealth to the HOLDCOS allowed for a separation of assets from the OPCOS. If ever a business setback would occur in OPCO, wealth would still be kept separate in HOLDCO. Usually HOLDCO was used for diversification perhaps holding real estate or investing in the stock market. Wealthy Canadians have their wealth tied up in these companies, not necessarily similar to the US situation.

The Tax Problem

Unlike the US, Canada does not impose succession taxes. However, the Income Tax Act does impose a deemed disposition of assets upon death.

This disposition results in tax paid on assets which have appreciated in value over the course of ownership by the deceased. The basic exception to this disposition occurs if the assets in question will be transferred to the spouse or a spouse trust. Thus, tax is imposed on the death of the second spouse. Since many Canadians maintain their wealth within HOLDCOS the advantage of tax deferral comes full circle upon death. The generation that amassed incredible wealth in the 60's, 70's and 80's, as they pass away, will be left with huge tax bills. Can our Canadian charities recognize the problem and offer to meet the needs of this generation?

The Theoretical Solution

The key lies in how the Act reads in prescribing when to calculate the deemed disposition. The Act prescribes that the deceased be deemed to have disposed of his/her assets immediately prior to death. The proceeds of disposition are "equal to the fair market value of the property immediately before the death". The solution would therefore be to reduce the value of assets before death and to replace the capital with assets received after death. The charity will help the donor reduce the value of assets prior to death and insurance will be used to replace the capital after death.

Insurance proceeds received upon death are received tax-free. If a corporation owns a policy upon the deceased, the proceeds from the policy will not be included in the value of the deceased's shares for deemed disposition purposes as the policy is not payable immediately prior to death. If cash surrender value (CSV) is attached to the policy, this CSV will be included in the value of the shares for deemed disposition purposes.

A gift to Charity from the company during the donor's lifetime will reduce the value of the shares upon death. Replacing the gift with insurance will convert a taxed asset on death into a non- taxed one, as described in the following example:

EXAMPLE 1

Mr. Caplan owns Company M, a holding company used to own a diverse group of assets. Its value is $10,000,000. His shares have a nil ACB and the company earns $500,000 a year. On death, Mr. Caplan's estate would remit capital gains tax on the $10,000,000 value. Co. M donates $1,000,000 to Charity ($250,000 a year for four years). Remember to always try to donate appreciated marketable securities. Over the four-year period, the company will save $500,000 of tax. With a portion of the tax savings, Co. M purchases a $1,000,000 insurance policy on the life of Mr. Caplan (premiums costing $60,000 per year).

Results

(1) A $1,000,000 gift is made to Charity from which the Charity will make Mr. Caplan's charitable gifts for the rest of his life. Assuming a 5% rate, the Charity will make $50,000 of donations annually, based on the advice of Mr. Caplan.
(2) A net profit will result equal to the tax savings less the insurance premium cost.
(3) One million dollars is removed from the company reducing its value for purposes of deemed disposition on death.
(4) A million dollars of insurance proceeds are received after death tax-free (and not included in the deemed disposition except for the cash surrender value of the policy).
(5) The beneficiaries receive the insurance proceeds personally tax-free to the extent of the capital dividend account created by the life insurance proceeds.

Insured Annuity

The theory is to reduce the value of the company during the lifetime of the shareholder to be replaced by insurance received after death. The Insured Annuity concept was reviewed in an earlier chapter. This should be considered in corporate estate planning.

The purchase of an annuity on the life of the shareholder will reduce the value of the company. Replacing the value with life insurance will create an estate planning advantage. The annuity is defined to be a life insurance contract. In the absence of cash surrender value, the economic value of the annuity will not be included in the value of the shares at death.

Note that the taxation of annuities in a corporation is calculated differently than if an individual receives an annuity. An individual will be taxed annually on the same amount. The corporation's taxable element of the annuity will vary over time as the corporate system follows the financial effect of an annuity more closely. Whatever the taxation, the effect for estate planning in the corporate setting is positive.

In summary, after-tax income is maintained, capital is maintained for the family, estate taxes are saved and a large endowment is gifted upon death.

EXAMPLE 2

Company M has $1,000,000 earning 7% annual income. After tax 3.5% is earned. Mr. Caplan has Company M purchase an annuity with $1,000,000 of cash. An annuity of $100,000 a year will be received by Company M for the rest of Mr. and Mrs. Caplan's life. Company M purchases a last-to-die policy on the lives of Mr. and Mrs. Caplan.

On the death of Mr. and Mrs. Caplan, the value of the shares of Company M have been reduced by $1,000,000, although the amount will be replaced by the receipt of the tax-free insurance proceeds.

Further, the amount will be passed to the beneficiaries without tax via the capital dividend account.

Annual annuity receipt	*$100,000*
Tax on income element of annuity	*(12,000)*
Cost of annual insurance premium	*(40,000)*
After tax income to Company M.	*$48,000*
Previous after-tax income	*$ 35,000*

Mr. Caplan has achieved an exciting estate tax savings. With the additional annual income of $13,000, Company M purchases another last- to-die policy on the lives of the Caplans with a face value of $625,000.

The beneficiary of the policy is the Charity. The cost of the premium of $25,000 will be tax deductible leaving an after-tax cost of $13,000.

Insurance

If a corporate insurance policy is treated as an investment the estate gift planning possibilities are extended.

EXAMPLE 3

Ms. Kim has her corporation purchase a universal insurance policy as described below:

The premiums are $180,000 a year for three years or $540,000. The policy is set to pay a death benefit of the premiums plus a 4% return plus $500,000.

On death the premiums are repaid/cashed in and if the death occurs in say 20 years $1,571,000 will be received evidencing a 4% after-tax investment. In addition, $500,000 will be received tax -free by the corporation which will be used to fund a gift to McGill.

This gift will be paid in one of two ways. Either the company will make the $500,000 gift and receive the charitable receipt, or alternatively, Ms. Kim will set up a $500,000 gift in her will. The company will declare a $500,000 dividend to the estate out of the capital dividend account created by the insurance proceeds. The dividend will be received tax -free and the estate will have $500,000 to pay the Charity gift, but will still pay the gift with marketable securities if possible. Thus, Ms. Kim's final tax return will contain a $500,000 receipt applied 100% against other income.

Subsection I64(6) and Will planning

A basic corporate estate planning strategy has been to have the corporation take out a policy on a shareholder. On death, the deceased's shares are redeemed by the company funded by the life insurance proceeds. In effect the capital gain in the deceased's return is replaced by a dividend to the estate which is non-taxable as the dividend is elected out of the capital dividend account arising from the life insurance proceeds. The Income Tax Act has been amended to reduce the capital loss to the estate upon the redemption of shares, which by virtue of subsection 164(6) is carried back to offset the deceased's capital gains to simplistically 50% of the dividend.

Consider utilizing the 50% opportunity and make a will gift to double the tax savings. And, since, as of January 1, 2016 the will gift can directly be used against the estate’s dividend income, planning is furthered with a will gift.

EXAMPLE 4

Mr. Aaron's shares of Aco are worth $11,000,000. Aco takes out a $3,000,000 policy on Mr. Aaron's life. Mr. Aaron's will provide for a discretionary gift to Charity for up to $3,000,000.

On death Mr. Aaron's final return will indicate $6,000,000 of taxable income due to the deemed disposition of Aco shares. The Estate's shares in Aco are redeemed for $3,000,000 cash (funded from the life insurance policy) and a $9,000,000 stock dividend of non-voting full ACB and PUC preferred shares.

The redemption creates a $11,000,000 dividend to the estate of which $9,000,000 is taxable as Aco elects $3,000,000 out of the CDA account created by the insurance proceeds. In addition, a capital loss of $11,000,000 is incurred which by virtue of subsection I64(6) is carried back to Mr. Aaron's return to eliminate the capital gain. The estate pays the gift to Charity. The donation receipt is used by the estate and not the final return (see chapter on Bequests).

In summary, on a net basis the 164(6) carry back using insurance will save about $1m of tax and the same insurance proceeds funding the gift will save a further $1.5m. The cost-the insurance premiums paid by the corporation.

The Peartree Canadian Gift Planning Handbook by Robert A. Kleinman FCPA, FCA

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