

Advisor notes

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“Freeze” shares and warm hearts

Many clients see charitable giving as an important part of their estate plan. Clients who own a private company also have an additional – and tax-savvy – charitable giving opportunity. Using an **Insured Excepted Gift** strategy, a donor can use private company shares to benefit a charity, immediately save tax, and help their family, too.

Caveat: This issue of *Advisor Notes* summarizes for discussion purposes only a concept involving very complex rules surrounding business valuation, share redemption and charitable donations. The scenario presented is for illustration purposes only and does not constitute a recommendation. Every client's situation is different and expert professional advice is essential.

Insured Excepted Gift (IEG) strategy: How it works

Private company shares donated directly to a public foundation or public charity are eligible for a charitable donation receipt. The *Income Tax Act* calls these donations “excepted” gifts. This forms the basis for the Insured Excepted Gift strategy, especially using special shares taken back as part of an estate freeze. Below is an example illustrating how this concept works.

Bob is the owner of GrowthCo Inc., a successful private company worth several million dollars. He is also a strong supporter of Charity A, a registered public charity. As part of his overall estate plan, Bob's advisors recommend that he arrange for a partial estate freeze. Bob wants to know if there is some way to unlock the value of his company to benefit Charity A, rather than paying a large amount of tax when he sells the company (or having his estate pay a large amount of tax when he dies). The answer is yes, the IEG strategy can help.

Here's how the plan works. Bob rolls over \$1.5 million of common shares in GrowthCo to preferred shares and then donates the preferred shares to Charity A. GrowthCo then buys life insurance on Bob's life to pay for a redemption of the preferred shares at Bob's death. When Bob dies, GrowthCo pays \$1.5 million to redeem the shares from Charity A. Bob's remaining common shares pass to his children, who are active in GrowthCo, and are Bob's natural successors in the business. The life insurance policy death benefit (minus its adjusted cost basis) creates a credit in the Capital Dividend Account that GrowthCo may use to pay tax-free dividends to Bob's children – and additional benefit of this strategy.

Preliminary matters

There are some technical requirements that Bob needs to satisfy before this transaction can deliver the results he wants to achieve:

1. Bob has to be insurable. Usually, applying for the life insurance policy is the first step, to make sure coverage is available at a reasonable cost before doing anything else.

2. The securities to be donated must be shares. Donations of debt instruments such as bonds will not generate the intended tax results.
3. Charity A must be a registered public charity.
4. Bob must deal at arm's length with Charity A.
5. Bob must deal at arm's length with each director, trustee, officer, etc. of Charity A.

Regarding the last requirement, Bob must not be on the board of Charity A; nor could he have any relationship with any of the officials of Charity A such as having his wife on Charity A's board, or acting as an official, paid or not, at Charity A.

Bob also needs to have GrowthCo valued, as if he were going to sell it. Valuing GrowthCo will help establish both the value of the shares that Charity A will receive and the charitable donation receipt that Bob will receive.

Estate Freeze

After satisfying the preliminary requirements, Bob's next step is to roll over \$1.5 million of his common shares in GrowthCo for preferred shares. Under section 85 of the Income Tax Act a rollover of those shares may be completed without triggering any immediate tax consequences.

The new preferred shares will have a total fixed redemption value of \$1.5 million, but will be split equally into two blocks, Class D and Class E preferred shares. Although Bob will not face any immediate tax consequences when he rolls his common shares into preferred shares, he will have to face some tax consequences when he donates those shares to Charity A. The Canada Revenue Agency (CRA) treats a charitable donation of shares as a disposition that triggers a realization of capital gains in the year of the donation. One way Bob can minimize capital gains tax exposure is by using his \$750,000 lifetime capital gains exemption to fix the adjusted cost basis on Class D's shares equal to its \$750,000 fixed redemption value (assuming that he has never used any of the exemption to this point). That way, the donation of the Class D preferred shares will not generate any capital gains tax liability.

Bob can also reduce his capital gains tax exposure by making a designation to reduce the value of the Class E shares (though not below the shares' ACB) when he donates them to Charity A. Of course, if Bob reduces the value of the Class E shares for capital gains tax purposes, he would also reduce the value of the charitable donation tax credit he could take. However, if Bob and his accountant believed that he might not be able to use the entire tax credit within the time allowed, it could be to Bob's advantage to make the designation reducing the value of the Class E shares.

GrowthCo buys life insurance on Bob's life

The next step is for GrowthCo to apply for a \$1.5 million Sun Life Financial insurance policy on Bob's life. Assuming that Bob is healthy, GrowthCo will own and be the beneficiary of a \$1.5 million policy on his life. The plan is for GrowthCo to own enough life insurance to redeem the donated shares at Bob's death, thereby ensuring that Charity A receives the cash from this transaction no later than when Bob dies.

Donation of preferred shares

After the life insurance policy is issued, Bob donates both blocks of preferred shares to Charity A. Charity A gives Bob a charitable donation receipt for \$1.5 million. Since GrowthCo was professionally valued, CRA will probably accept the value for the shares (though it can challenge the valuation if it chooses to).

Bob may use his donation receipt to take a credit against the tax due on up to 75% of his income for the year of the gift. If he cannot use the entire credit in one year, he can carry it forward for up to five more years, giving him up to six opportunities to use the credit.

Of course, as previously discussed, the donation is treated as a disposition of the shares, just as if Bob had sold them. There will be no capital gains consequences for the disposition of the Class D shares, the block where Bob had used his lifetime \$750,000 capital gains exemption to adjust the ACB of the shares to \$750,000. However, the Class E shares will generate a capital gain on the entire share value. Bob will have to include half of that disposition, \$375,000, in income for the year of the donation.

If we assume that Bob pays tax at a 40% overall rate, the capital gain on the Class E shares will generate a \$150,000 tax bill (half of the \$750,000 capital gain, or \$375,000, is taken into income; tax of 40% on that amount is \$150,000). However, the \$1.5 million donation will generate a tax credit that Bob hopes he can use to offset up to \$600,000 in taxes over a six-year period – a potential \$450,000 reduction in income taxes. Because of the potential for a large reduction in tax, Bob is not willing to designate a lower value for the Class E shares – he believes that he can use the entire tax credit within the time allowed.

Charity A's ownership of GrowthCo preferred shares

Charity A has several options as to how it deals with its GrowthCo preferred shares.

1. **Take Dividends.** Most preferred shares pay a fixed dividend, though dividend payment obligations are not required with preferred shares. Charity A could receive dividends if the right to receive dividends were fixed or if GrowthCo declared dividends on the preferred shares. Dividends are taxable, but Charity A will not pay any tax since it is a tax-exempt entity. Neither GrowthCo nor Bob would get any tax relief for any dividends paid to Charity A since those dividends would not be treated as a donation but instead as a right attached to Charity A's share ownership.
2. **Participate in a liquidation of GrowthCo.** Although GrowthCo is a successful business, the possibility of failure is always present. If GrowthCo were to fail, Charity A would have a preference over the common shares in receiving any money that a sale of the company's assets generated. However, preferred shares rank behind ordinary and secured creditors. Creditors are entitled to have their claims completely satisfied before preferred shareholders' claims may be considered.
3. **Hold the shares until they are redeemed during Bob's life.** GrowthCo could also decide to redeem Charity A's GrowthCo preferred shares during Bob's life. If that were to happen, GrowthCo would pay Charity A \$1.5 million for the shares.
4. **Hold the shares until they are redeemed at Bob's death.** GrowthCo could also redeem Charity A's preferred shares at Bob's death. This is the main reason for having life insurance on Bob's life. At Bob's death, GrowthCo will receive \$1.5 million in death benefit proceeds. It could use the proceeds of insurance to redeem Charity A's preferred shares in GrowthCo for \$1.5 million.

Assuming GrowthCo does not redeem Charity A's shares until Bob's death, an added benefit from GrowthCo's owning insurance on Bob's life is that the receipt of the death benefit would give GrowthCo a credit to its capital dividend account equal to the proceeds of insurance minus the adjusted cost basis. Even if GrowthCo used the death benefit to redeem Charity A's shares, it could still pay capital dividends to its shareholders. If Bob's shares passed to his children as planned, they could take profits from GrowthCo tax-free to the extent of the capital dividend account.

One option for Charity A – selling the shares – is likely not available. Charity A's shares probably carry restrictions on a shareholder's right to transfer the shares, and may not have a fixed right to received annual dividends. Further, since the shares' voting rights would be severely restricted, a preferred shareholder would not be able to exercise much if any control over the direction of GrowthCo. As a result, even if Charity A had the legal right to sell its shares, it likely would find them unmarketable.

Another option is for Bob to sell GrowthCo. If he were to do that, he would have to recognize capital gains on the sale of his remaining common shares. However, if he sold his shares in GrowthCo shortly after donating the preferred shares to Charity A his charitable donation receipt could help him offset some or all of the income tax owing on the sale.

Differences between donations of publicly-traded shares versus shares in a private company

This strategy involves the donation of shares in a private company, as opposed to a publicly-listed company. There are different tax benefits associated with donations of each type of shares. Donations of shares in a publicly-listed company result in a charitable donation receipt that may be used to eliminate tax on up to 100% of the donor's income. Further, such donations do not attract capital gains tax. On the other hand, while a donation of shares in a private company attracts capital gains tax and allows the donor to eliminate tax on up to only 75% of income, the \$750,000 lifetime capital gains exemption is not available for use with publicly traded shares – it applies only to dispositions of shares in private companies.

Capital gains exposure on the private company shares can also be reduced by electing to value the shares at less than their fair market value (though the charitable donation receipt is correspondingly reduced). Finally, having the private company own a life insurance policy and receive the death benefit to redeem a charity's shares in that company creates capital dividend account room to the extent that the death benefit exceeds the policy's adjusted cost basis, and allows the private company to pay tax-free dividends to that extent, an important benefit for the surviving shareholders.

Conclusion and a word of caution

By transferring some of the value in his company to Charity A, and having his company use life insurance to help pay for a redemption of those shares, Bob accomplishes several objectives:

1. He makes a substantial gift to Charity A.
2. He generates significant tax savings for himself.
3. He creates capital dividend account room that allows profits to be distributed from GrowthCo after his death tax-free.

Bob's situation is merely an example, and not a recommendation. It is designed purely to highlight several possible aspects of private company share donation.

This issue of *Advisor Notes* summarizes a concept involving very complex rules. For example, some provinces have restrictions on charitable ownership of business shares. Reorganization of corporate articles means extensive legal, accounting and valuation work will be required. Every situation is different, and expert professional advice will be required.

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