Planned Giving:
Private Corporations and Private Foundations

By Larry Frostiak, CA, CFP, TEP

INTRODUCTION

Planned giving is a growing phenomenon in Canada. It involves the careful consideration of all the assets and options of the donor that ultimately results in a gift. A key person when most donors are considering a planned gift should be, and often is, the accountant.

When looking at a donor's – your client's – planned gift options, one of the most underutilized areas of gifting involves privately held companies. One of many reasons for this is that the *Income Tax Act of Canada* (ITA) has numerous sections that deal with such property when gifted to registered charities – rules that serve to effectively deter most charities from actively soliciting such property. While charities may not choose to solicit such gifts, they will have to establish policies and procedures to effectively deal with them, because privately held securities are being gifted through bequest situations.

This article examines the "planned giving" strategies and the tax consequences arising from the gift of private company shares, and the use of a private foundation as a planning mechanism.

The opportunities for effective tax planning and the ability to implement a "planned giving" strategy are enormous. Given the considerable wealth held in private corporations across Canada, estate planners should be examining the opportunities of such "planned giving" strategies with their clients.

This article will highlight some of the key technical aspects dealing with charitable giving and the use of a private foundation. Effective planning can be implemented with privately owned shares of an investment holding company and also with other "non-liquid" assets such as commercial real estate. (Reference an earlier article appearing in the CGA Magazine, December 2003, entitled: "Planned Giving: Creative Solutions to Estate Taxation Issues, by DeWayne Osborn, CGA, CFP and Larry Frostiak, CA, CFP, TEP). This article however, cannot begin to comprehend all of the tax implications relating to a "planned giving" strategy, and consequently the estate planner should obtain the advice of an experienced professional to assist in any such strategy.

WHAT ARE THE TAX RULES?

Registered Charity

A registered charity can be an organization, corporation, or trust registered with the Minister of National Revenue. A registered charity must fall under one of the following three entities:

- a charitable organization;
- a public foundation; or
- a private foundation.

It is the third category (private foundation), which is the subject of this article.

Private Foundations

A "Private Foundation" is defined in Sec.149.1(1) of the ITA as a charitable foundation that is not a public foundation. Private foundations usually meet their charitable activity requirements ("disbursement quota") by funding other charities. A private foundation generally receives more than 50% of its funding from related donors and/or more than 50% of its Board of Directors are related to each other.

Related Persons

Related persons, under the Income Tax Act (Canada) includes individuals who are related to each other by blood, marriage, adoption or by common-law marriage.
Persons who are related are deemed to deal "not at arm's length" under the Income Tax Act (Canada). The concept of non-arm's length is significant with respect to the planning for private foundations, as discussed below in "non-qualifying securities".

Non-Qualifying Security: Private Foundations

The concept of a "non-qualifying security" is specifically defined in section 118.1(18) of the Act to include:

- a debt owing to the foundation; or
- any "non-listed" share of a class of stock from a corporation with which the private foundation does not deal at arm's length ("related persons") with the donor.

There are specific restrictions inscripted in the Act which deny the charitable tax credit to the donor, when a related person makes a gift of a "non-qualifying security" to a private foundation. The main exception to this restriction is when a gift results in the private foundation acquiring control of the corporation. In this situation, the "related donor" no longer controls the corporation after the gift and accordingly, the gift could not be considered to be a "non-qualifying security".

If a gift constitutes a non-qualifying security, the charitable donation amount is deferred until such time as the security is no longer considered to be a "non-qualifying security". This can occur as outlined in section 118.1(13) of the Act if:

(1) the donor and the charity cease to deal not at arm' length, within 60 months from the date of the gift; or
(2) the non-qualifying security is sold by the charity within 60 months from the date of the gift; or
(3) the non-qualifying security ceases to be a non-listed security, share, or obligation

(e.g.: exchanged for a public security) within 60 months from the date of the gift.

If any one of these events occur, the private foundation can then issue a charitable tax receipt for the lesser of the following amounts:

- the fair market value (FMV) of the security when it ceases to be a non-qualifying security; and
- the fair market value of the security at the date when it was originally gifted.

<u>Disbursement Quota – Private Foundation</u>

The disbursement quota for a taxation year of a charitable foundation is defined in subsection 149.1(1) of the Act for the purpose of determining the amount the charity is required to spend on charitable activities or gifts to other charities.

The definition "disbursement quota" was amended by subsection 248(30) of the Act, in respect of gifts made after December 20,2002 to provide that the amount of the gift for which a tax receipt can be issued is restricted to the "eligible amount" of the gift.

Failure to meet the "disbursement quota" requirement may result in the revocation of the registration of the private foundation (par.149.1(4) of the Act).

In any given taxation year, a private foundation must spend at least 80% of its revenue for which it issued tax receipts in the immediately preceding tax year.

In addition to the annual 80% disbursement quota requirement for annual gifts, a private foundation must disburse 100% of gifts received from other charities, excepting certain specified "gifts".

<u>Ten-Year Gifts</u>

Where a registered charity receives a gift subject to a trust or a direction by the donor that the property gifted (or substituted property), be held by the charity for a period of not less than 10 years, the gift (and the subsequent growth on the gift), is excluded from the "income" of the charity for purposes of the charity's "disbursement quota", by virtue of paragraph 149.1(12)(b)(i) of the Act.

CCRA's policies on such "10-year gifts" are also outlined in paragraph 6 of IT-244R3.

Gifts which bear a specific written direction from the donor, which require that they be held for a period of not less than ten years, are therefore not subject to the annual 80% disbursement quota requirement. This direction by the donor can include interest and/or capital gains earned or accrued on the property.

The ability to use the "ten-year gift" designation is particularly useful for a gift of shares of a privately owned corporation, since the property itself may not initially have a great deal of liquidity.

The wording for a "ten-year gift" should include the following information:

- Donor's name and address;
- Donor's signature;
- The charity's full legal name and CCRA business number;
- The amount or value of the gift;
- The date of the gift;
- The tax receipt number issued to the donor; and
- A written direction to the private foundation to hold the property (or substituted property) for a period of not less than ten years from the date of the gift.

Specified Gifts

A "specified gift" is defined in section 149.1(1) of the Act. Such gifts permit for the transfer of funds between charities without affecting the disbursement quota of either charity. The receiving charity is not required to include a "special gift" as part of the amount subject to its disbursements quota. Conversely, the disbursing charity cannot claim the "specified gift" as part of its charitable activities.

Gifts of Capital Properties to a Charity

a) *Gifts made Through the Will*
Gifts by way of a Will are described in the Act under section 118.1(5) to permit donations made by way of direction in the Will, to be deemed to have been made by the individual immediately prior to death.

This deeming provision is important, because section 118.1(4) permits donations made in the year of death, which cannot be claimed in the year of death, to be carried back to the immediately preceding taxation year and claimed in that year, to the extent that there is available room.

Gifts made through the Will can be claimed by the individual as follows:

- to a maximum of 100% of income in the year of death; and
- to a maximum of 100% of income in the immediately preceding taxation year

b) *Designation of a Gifted Property*
Generally, a taxpayer who disposes of a capital property by way of an inter-vivos gift, or an individual who is deemed to dispose of a capital property as a consequence of death, is deemed to have received proceeds of disposition equal to the fair market value (FMV) of the property at the time of the disposition, by virtue of paragraphs 69(1)(b) and 70(5)(a) respectively.

If the FMV of the capital property exceeds the adjusted cost base (ACB) of the property, the individual will realize a capital gain for tax purposes. This situation can occur as a result of a direction to make a gift of a capital property during the individual's lifetime or as a result of a direction to do so under the Will.

However, subsection 118.1(6) of the Act provides for a designation which can reduce the capital gain that would otherwise result from such disposition (or deemed disposition), when the individual makes a gift or bequest of the capital property to a registered charity, including a private foundation. (See also IT 288 R2 Gifts of Capital Properties to a Charity and Others).

Subsections 110.1(3) and 118.1(6) permit a taxpayer, who makes a qualifying gift of a capital property (or the taxpayer's legal representative) to "designate" a value for the gift for any amount which is not less than the ACB of the property and not greater than the FMV of the property, at the time the gift is made.

The designated amount is deemed to be the proceeds of disposition of the property to the taxpayer and it is also deemed to be the "amount" for purposes of determining the deduction or the donation tax credit under subsection 110.1(1) or 118.1(1) or the Act.

PLANNED GIVING STRATEGIES

<u>Shares of a Privately Owned Investment Holding Corporation</u>

<u>The Problem:</u>

Consider the situation of a privately owned holding corporation with assets which might include publicly traded securities and other investment holdings. The corporation also has a significant balance in its "refundable dividend tax on hand" (RDTOH) account. This corporation may have carried on an active business as a small business corporation ("SBC") many years ago, but after selling its operating assets and business "goodwill", the corporation invested and re-invested the after tax sale proceeds corporately, and continued to accumulate ongoing wealth.

The shareholder of the corporation has not liquidated the corporation because there has been no immediate cash need and to do so would merely trigger a considerable degree of corporate and personal tax. The shareholder has heirs who he wishes to benefit on his passing; however, the shareholder has charitable giving intentions which are connected to a longer-term goal of building a "lasting legacy." In many cases, these shares would represent the bulk of the shareholder's personal net worth on death.

So . . . what can be done?

The shareholder could provide for a "Will Gift" of a "controlling portion" of the shares of the company to a Registered Charity, assuming that a public charity would want to receive such a gift. However, the gift creates a precarious situation for his heirs, as they would no longer "control" the "family corporation" and the family may be in no position to realize on their inheritance. Public charities generally do not wish to receive shares of privately owned corporations. This would particularly be so, where family members continue to hold an interest in the company.

The testator could gift all of the shares to the Charity on his passing, but this would effectively eliminate any wealth transfer to his heirs. Also, if there is any RDTOH in the company, any "personal benefit" from this tax asset would be forfeited in favour of the Charity.

Finally, the testator could direct the "wind-up" and liquidation of the corporation by his legal representatives, conditional on his death with the distribution of the liquidated assets to his heirs and to the charity. Of course, this option may result in a considerable amount of corporate and estate tax, before the heirs and the charity get to enjoy any of the remaining wealth.

Not only that, the testator will sense a loss of control over his principal asset if it has to be "carved-up" and distributed with a sizable chunk ending up with CCRA!

The Solution!

A better estate planning solution involves the use of a private foundation, created during the lifetime of the principal shareholder. A private foundation can afford the principal with the assurance that a degree of control can continue to be exercised over the future use and direction of the donated proceeds, as entrusted to the directors of the private foundation, with whom he is comfortable.

Assuming that the testator wishes to bequeath a fixed sum to his heirs and then provide for a gift-over of the remaining assets to charity, the following "Planned Giving" strategy could be implemented:

The following example (as illustrated below) is set out to demonstrate the benefits of an effective "Planned Giving" strategy.

Existing Structure

Shareholder

100% of the shares

HOLDCO

ACB = $100
PUC = $100
RDTOH = $6,000,000
Investments - $FMV = $30,000,000
The shareholder is pre-deceased by the spouse and there are children living who will inherit some of the wealth (15,000,000). The remaining value ($15,000,000) will be gifted to Charity as a "lasting legacy."

The Plan

The shareholder would incorporate a "private foundation", as defined in section 149.1(1) of the Act. Two of the three directors of the private foundation would not be related to the shareholder and they should "deal at arm's length" with HOLDCO for tax purposes. The third director of the private corporation may well be the shareholder (during his/her lifetime) and such other person as appointed by the Will. The appointee could be a surviving child or another relative named under the Will.

HOLDCO would then undertake a Section 86(1) Reorganization of Capital wherein all shares of the corporation owned by the shareholder are exchanged for $18,000,000 of special preference ("freeze") shares and new common shares for share consideration having an aggregate value equivalent to the "old" shares of HOLDCO prior to the Section 86(1) Reorganization.

The $18,000,000 of special preference freeze shares held by the shareholder in HOLDCO would then be "put" for redemption, resulting in the payment of a deemed dividend of $18,000,000 on the cancellation of such shares.

Consideration payable to the shareholder would be a demand promissory note with interest payable at market rates.

The redemption of these shares results in the payment of a deemed dividend to the shareholder as contemplated under paragraph 84(1) of the Act. This "taxable dividend" triggers a dividend refund to the corporation of $6,000,000 ($1 for every $3 of dividends paid). The corporation therefore has a pre-distribution value of $36,000,000 in aggregate with the "freeze" shares representing an overall value of $18,000,000 or 50 percent of the overall corporate value.

The shareholder then makes an inter-vivos gift of the remaining common shares in HOLDCO to the private foundation. The gift results in a disposition and deemed proceeds at FMV, pursuant to the provisions of paragraph 69(1)(b) of the Act. The resulting disposition, will, absent a 118.1(6) designation, result in a capital gain of $18,000,000 to the individual taxpayer.

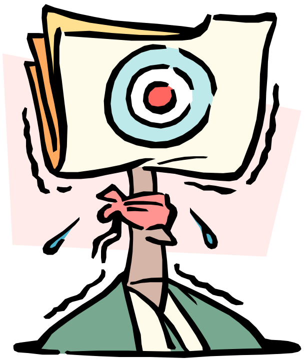
The gift of the common shares of Holdco would be designated as a 10-year gift in accordance with the provisions of par. 149.1(12)(b)(i) of the Act, thereby avoiding any immediate disbursement quota issues. However, the "gift" also creates a donation amount of $18,000,000 (equivalent to the FMV of the gift) as provided in section 118.1 of the Act ("total charitable gifts").

Of the resulting gain, one-half or $9,000,000 is subject to tax.

The overall tax implications to the shareholder are detailed below. While there would be a net tax cost of $1,365,000 to effect this "planned giving" strategy, the shareholder's estate plan and charitable giving strategy is effectively and solidly put into place. The shareholder can fund the $1,365,000 in net tax cost by "drawing-down" on the $18,000,000 promissory note held in HOLDCO. The cash to pay this tax can be funded from the dividend refund received from CCRA, leaving the investments in the HOLDCO intact.

While there is some immediate tax cost triggered in this estate plan, the costs are effectively funded by CCRA through the

RDTOH mechanism. Moreover, a "do-nothing" approach would result in personal capital gains taxes on death amounting to $7,500,000 or more.



If the shareholder has unutilized individual net capital losses available, the personal tax cost resulting from this planned giving strategy can be further reduced.

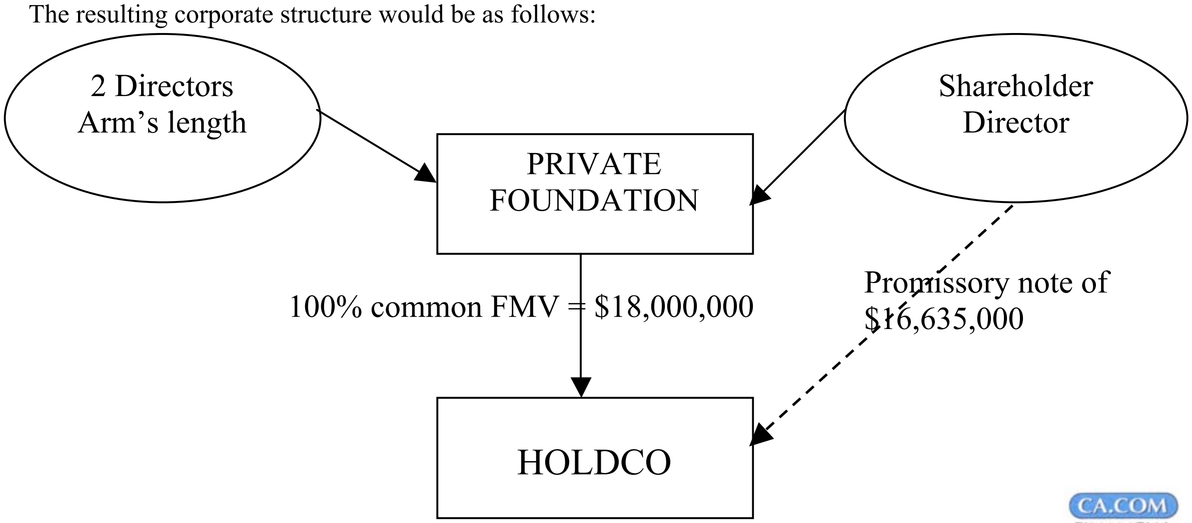
Alternatively, this strategy can also be deferred and implemented on a "post-mortem" basis pursuant to the wishes set out in the testator's Will, provided that the private foundation is in place and that the Will is sufficiently clear and broad enough in scope to permit the legal representative or executor to carry out such restructuring on a "post-mortem" basis.

The tax implications for this example are summarized below:

<u>Tax Implications to Individual Shareholder</u>

Deemed dividend on redemption of preference shares	$18,000,000
Gross up @ _	4,500,000
	22,500,000
Taxable capital gain on "gift" of capital property – common shares	9,000,000
Taxable income	$31,500,000
Tax thereon	
Federal – basic @ 29%	$9,135,000
Dividend tax credit	(3,000,000)
Donation credit on $18,000,000 gift	(5,220,000)
Federal tax	$915,000
Provincial tax (approx)	450,000
	$1,365,000

The resulting corporate structure would be as follows:



ADVANTAGES

(a) All future tax costs on death are eliminated

(b) The shareholder enjoys a tax paid shareholder loan of 16.6 million dollars, which can bear interest at market rates.

(c) The $16.6 million tax paid loan can be gifted by the shareholder on his death to the surviving beneficiaries, with no additional resulting tax cost.

(d) The estate is simplified and the beneficiaries are absolved from dealing with a potentially complicated and tax-costly Estate situation.

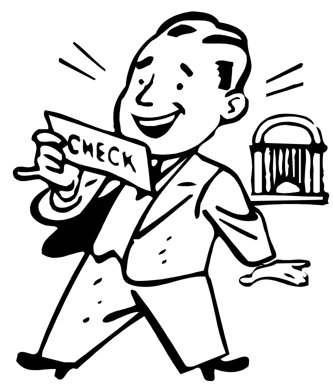
(e) The shareholder can fulfill his charitable giving intentions by creating and leaving a "lasting legacy" under the name of his own private foundation.

(f) The directors of the private foundation will continue to administer and direct gifts for charitable purposes on an ongoing basis. The private foundation can accommodate one or more family members as directors. The arm's length" requirement is no longer an issue in so far as a family member does not control HOLDCO

(g) HOLDCO can tax-efficiently fund the private foundation with cash. Income earned by HOLDCO can be paid by way of taxable dividend to the private foundation.

The dividend received by the private foundation will not be subject to tax since the private foundation is considered a "registered charity" for tax purposes and exempt from tax as provided for under paragraph 149(1)(f) of the Act. HOLDCO would however, continue to generate and recover RDTOH with the result that the ongoing effective tax rate would be only around 26 percent in most provincial jurisdictions.

This strategy will continue to provide a significant after tax cash flow of income to service both the demand note to the shareholder (or his beneficiaries), plus provide funding for the private foundation.



About the Author

Larry Frostiak, CA, CFP, TEP, received his Chartered Accountancy Designation in 1981 and is a founding partner of Frostiak & Leslie Chartered Accountants Inc. in Winnipeg. He specializes in tax planning for owner-managed corporations and their shareholders, corporate reorganizations, business sales and acquisitions, and estate planning and taxation of family trusts. Larry also provides financial and wealth management services to assist clients with "tax-efficiently" structured portfolios and financial, estate, and succession issues. Mr. Frostiak has instructed at the Canadian Institute of Chartered Accounts' In Depth Tax Course and has lectured for the Winnipeg School Divisions (Continuing Education Programs) and various accounting courses for the University of Manitoba. He has also authored many published articles on tax issues over the past several years.

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