

# GIFTING PRIVATE COMPANY PREFERRED SHARES

by

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## INTRODUCTION

Canadians hold much of their wealth in private companies. The Canadian corporation offers its shareholders limited liability but more, an excellent structure to build and maintain businesses and investments. The Income Tax Act, Canada allows for Canadians to reorganize their affairs within corporations, usually in a tax-free manner, which further gives value to the corporate system.

Making a gift to a Canadian charity of private-company shares is certainly a viable alternative. As a gift-planning tool such a gift can be a powerful mechanism for a donor wishing to make a substantial gift to a charity and/or create long-term philanthropy. Such a gift can be part of an estate plan for a family, yielding very positive tax results and a family philanthropy long-term structure.

The weakness of such a gift is the intermingling of one's charity with personal holdings. Shares of private companies are usually common or preferred. Common shares are growth shares of a company. Preferred are usually (but not always) set in value. Thus, a donor of private-company shares usually donates preferred shares-the value or gift is set and known and will not affect the future growth of the company. There are, however, many issues, which arise- voting issues, liquidity, dividends and many others that make such a gift much more complicated.

### **The objectives of this article are to:**

- 1) Review the legislation surrounding this form of gift;
- 2) Examine new legislation aimed at curbing tax shelter abuses which unfortunately affects gifts of private-company shares;
- 3) Introduce some estate planning strategies surrounding this form of gift; and
- 4) Set out a checklist of items to consider when making or accepting such a gift.

I refer to an excellent article entitled "**Valuing Private-Company Preferred Shares**" written by Richard M. Wise FCA, FCBV, ASA, MCBA. Richard is a Canadian lion in the field of valuation. He is also a volunteer of the Jewish Community Foundation of Montreal and wrote this article, as a gift to us (of course non-receipted) to help us in our acceptance of these gifts. For those readers not knowledgeable on the attributes of preferred shares his article contains a very useful review of these forms of shares. Richard's article can be accessed at [www.jcfmontreal.org/valuingpreferredshares.pdf](http://www.jcfmontreal.org/valuingpreferredshares.pdf). For those readers not knowledgeable on the basics on how these shares are taxed on sale or redemption there is a small appendix at the end of this paper.

## TAX LEGISLATION RE GIFTING OF PRIVATE-COMPANY SHARES

### **Non-Qualifying Security**

The Income Tax Act sets out a methodology of taxation of gifts of private company shares 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, 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. The preponderance of gifts of private company shares to public charities should not be affected by the new rules unless, of course, 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. This may be problematic as it is often the volunteers of a charity who feel most inclined to donate to that charity.

### **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, 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 would 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. The reason for this is that 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 would occur without the possibility of the deceased being able to use it on a tax return. Thus, 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. 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.

## **APPLICATION OF THE RULES**

### **Public Charities**

It is clear that except for gifts of debt, the gift of private company shares is fully acceptable to public charities (charitable organizations and public foundations). The only difficulty lies with the special rule that the donor must be at arm's length with the directors and officers of the public charity. Of course, being a member of a Board of Directors of a charity does not constitute in itself the ability to control a charity.

However, the fact that a potential donor of private company shares is a member of the Board would, in essence, mean that the shares transferred would be non-qualifying security. Thus, it appears necessary for the Board member to resign prior to the gift. If the charity still owns the shares five years after the original gift, then the donor can come back onto the Board of Directors at that point in time.

Note that it's not just the donor that may not be a Board member, but also anyone related to him/her including children, parents or spouse for purposes of the Income Tax Act. Also, the term that is used in the Act is "not at arm's length" which is more than simply family relations. It is a question of fact whether one does not deal at arm's length with another person or entity. Thus, if it could be shown that a donor controls the charity without being on the Board or has undue influence, then CRA may determine that such a donor does not deal at arm's length with the charity.

### **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 were 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.

### **Reducing Cost Base**

In the case of a non-qualifying security with a substantial cost base, one may wish to reduce the cost base prior to affecting the gift. Perhaps a reorganization of capital, a Section 85 transfer or a return of capital, allocating the cost base to non-share consideration would result in low cost base shares to be gifted tax effectively.

Assume an individual owns \$2 million of preferred shares with a paid-up capital and a cost base of \$200,000. It is intended that these shares be transferred to a private foundation. Prior to the gift, the company would return \$200,000 of capital from these shares to the individual. Due to the paid-up capital and cost base of \$200,000, no capital gain or dividend would result on the payment of the \$200,000 to the shareholder.

The shareholder could decide to loan the \$200,000 to the company. The preferred shares would now have a value of \$1.8 million instead of \$2 million, but would have a nil cost base. A gift of these shares to the public foundation would result in a non-qualifying security being gifted and, therefore, non-recognition of the gift. With an election pursuant to 118.1(6) or just the use of the reserve system for five years for the non-qualifying security gift, no tax would be payable on the transfer to the foundation.

### **Super Capital Gains Exemption Shares**

Legislation exists to exempt up to \$500,000 of capital gains realized on the disposition of farm property and shares of small business corporations, essentially private companies operating active businesses in Canada. Many owners of such companies have crystallized this exemption, effectively disposing of their shares and receiving back other shares of their private company.

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

### **Conversion of Debt to Shares**

One of the severe limitations of the new rules is the effective inability to claim a donation receipt for full cost base gifts of debt to charities whether public or private. Particularly in gifts to public charities where full cost base shares would entitle the donor to a full receipt, this inability to do the same with full cost base debt is limiting. However, one of the practical realities of holdings of shares and debt in a private company situation is that it is very easy to convert one into the other.

For example, if one owned a \$100,000 debt receivable from a company he controls, it is very easy to convert the debt into \$100,000 of preferred shares which would hold a high cost base. After the conversion, one could donate the preferred to a public charity and receive a full tax receipt. The difference between gifting shares and debt is that for debt, the income that is paid to the charity subsequently would be interest expense of the payer corporation and often tax deductible. In the case of shares, the income that would be paid on the shares subsequent to the gift, dividends are not deductible to the corporation and, therefore, may not be as desirable.

There is nothing in the legislation, which stops a company from converting its shares owned by a public charity into debt after five years from the original date of the gift. Therefore, the legislation does appear to allow for some manoeuvring either prior to the gift or after five years, which could benefit the donors. Of course one should weigh the possible application of the General Anti-avoidance Rules to these transactions.

### **Disbursement Quota**

The gifting of shares to a charity does create value in the charity. If the gift were a ten-year gift for purposes of the Income Tax Act, then the annual disbursement quota responsibility would be, simplistically 3.5% of the share value. Particularly in the case of a gift into a private foundation one must ensure that the company does pay out the proper amount of dividends to the private foundation to enable that foundation to spend 3.5% of its capital on an annual basis on charitable activities.

The rules in terms of disbursement quota are very similar for public charities and foundations and, therefore, the 3.5% rule must be accommodated. Of course, in a public charity there may be a vast array of assets in the public charity so that, in essence, the computations of disbursement quotas are merged together. In other words, the disbursement quota is not on a gift-by-gift basis but on a charity-by-charity basis and, therefore, it may not be as necessary for a full 3.5% dividend to be paid in a public charity situation.

### **Valuation**

Valuation of private share gifts is tricky and of concern to CRA. To issue receipts, charities, especially for major gifts should rely on valuation reports of qualified professionals. Retractability of shares, liquidity of the company, cumulative dividend rights, and many other factors will affect valuation. Thus, \$2 million of preferred shares gifted to a charity might not be worth \$2 million if the shares are not liquid nor subject to a market return. In an estate planning situation, where one of the hoped for results is the reduction of the tax liability on death, then valuation may not be important especially if the gift is of a non-qualifying security and a donation receipt is not expected. In this case creating value is less important as the receipt is not to be used.

*Please refer to Richard Wise's article for an examination of this issue.*

### **Liquidity**

Is it necessary for the shares, after the gift to the charity, to be turned into cash- not necessarily? If the shares throw-off adequate dividends and the intention is to have created an endowment, then the charity may be pleased to maintain the ownership of shares. If not, a schedule of redemption should be entered into at the time of gift, which is satisfactory to the charity.

Another method to achieve liquidation, although not in the short term is for the company to take out an insurance policy on one or more members of the family. Upon receiving insurance proceeds upon death,

the company will redeem the shares (leaving the capital dividend account to benefit the surviving shareholders).

## **TAX SHELTER LEGISLATION – AFFECTS GIFTS OF PRIVATE-COMPANY SHARES**

On December 3, 2003 Minister of Finance John Manley released draft amendments to the Income Tax Act aimed at limiting the tax benefits of charitable donations made under certain tax shelter arrangements.

New subsections 248(35)-(37) of the Act work to deem the fair market value of a donation (and therefore the tax receipt the donor will receive) to the lesser of its normal value and its cost base for tax purposes where the property was acquired within three years of the gift. This rule does not apply to a gift at death or for a gift of inventory, ecological property, Canadian cultural property, listed securities (marketable securities) and real estate.

Unfortunately gifts of private-company shares are not exempted. Often individuals own preferred shares of their companies at low or little cost. These shares could be donated in many situations. However, if the shares were acquired within three years, say by virtue of a reorganization of capital, the ultimate tax receipt would be reduced.

In a conversation with Lorne Richter of the C.A. firm SNG in Montreal, on January 12, 2005, Ed Short of Finance indicated that private company shares that have been acquired by the donor as consideration for exempted assets, inventory, real estate, listed securities, etc. would also be exempted from the three-year hold rule. However, the reader is cautioned that the Act does not yet read this way today, although presumably it will.

These rules are an additional impediment, but they shouldn't be a problem if:

- 1) A receipt is not required. A donor can always elect the proceeds of disposition for tax purposes to be equal to the cost base to ensure if no receipt results that also no capital gain is realized;
- 2) Shares were acquired prior to three years;
- 3) Cost base is high, even equal to fair market value; or
- 4) Gift of the shares is from a will (on death).

## **ESTATE AND OTHER PLANNING**

### **Estate Freeze**

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

Consider a situation where an estate freeze has occurred whereby 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. If this spouse were to pass away then the deemed disposition rules would operate such that the preferred shares worth \$5 million would be subject to a tax upon death yielding a tax liability of perhaps \$1.7 million.

Instead, a gift of these shares either prior to death or in the will to a charity would remove the tax liability. If the transfer were to a private foundation controlled by the family, then the shares would be non-qualifying securities and, therefore, it is probable that one would arrange so that no capital gain would occur but also no charitable donation receipt useable.

If the gift of the preferred shares were made to a public charity of which the family was dealing at arm's length, then the shares would not be considered non-qualifying and the donor would be entitled to a full \$5 million charitable donation receipt (assuming the value of the shares are \$5 million) and at the same time a taxable capital gain of 1/2 of the value or \$2.5 million (assuming zero cost base) would be realized. The \$2.5 million taxable capital gain would be sheltered by \$2.5 million of the charity receipt with the balance of the receipt, \$2.5 million, applicable against 75% of other income of the donor earned in the year or the subsequent five following years. If this gift had occurred in the will, then the extra \$2.5 million receipt could be applicable against 100% of other taxable income created due to the death of the second spouse. If no such other income will result, then it may be advisable to make the gift during lifetime so that the receipt can be useable against taxable income, which could be created in the five following years after the gift.

By gifting to a public foundation there is obviously less control over the ultimate cashing in of the preferred shares. This is, of course, dependent on the attributes of the preferred shares. If the preferred shares are retractable, i.e. redeemable at the option of the holder, then the public charity would have the right to demand retraction at any time. Therefore, the family might create a shareholders' agreement limiting all the shareholders from demanding retraction of preferred shares. These gifts transferred to the charity then would be subject to the shareholders' agreement. This shareholders' agreement, though, might affect the value of these shares for the issuance of the donation receipt.

As noted above the purchase of an insurance policy to fund the redemption of shares can be a terrific component of the plan. Often the cost of the insurance is less than the tax savings achieved and thus philanthropy is created at low cost.

## **RDTOH**

Companies earning investment income in Canada pay substantial cash tax, a portion of which is refundable if the corporation pays out taxable dividends to its shareholders.

The amount potentially subject to refund is called Refundable Tax on Hand or RDTOH. A refund is received of \$1 of RDTOH for every \$3 of dividends paid.

An individual owning a company with a substantial RDTOH balance might consider donating preferred shares and obtaining the personal donation tax credits. Any dividends paid on the shares or any redemption of the shares (assume low paid-up-capital shares) will result in taxable dividends paid to the charity (although the charity does not pay tax on its income) and the company receiving dividend refunds. This can create some positive cash flow results.

## Intercorporate Holdings

Corporation A disposes of assets resulting in substantial taxable income. The shareholders wish, as a result of the success, to create a charitable endowment. Corporation A controls Corporation B.

Corporation A purchases \$1,000, 000 of preferred in Company B. This holding is gifted to a public charity. A full receipt is received (assume full value) and no capital gain arises due to the high cost base of the shares.

### CHECKLIST FOR CHARITIES RECEIVING PREFERRED SHARES AS A GIFT

- 1) Determine status of shares under the Act.
  - are they non-qualified securities?
  - is the gift an excepted gift?
  - is the donor at arm's length to the charity?
- 2) Describe the shares to be gifted- number, class, redemption value, voting, retractability, participating, dividend rate, cumulative, cost basis, paid-up-capital;
- 3) How and when were the shares acquired- will their fair market value be deemed to be their cost?
- 4) Evaluate the company- assuming the shares will not be redeemed immediately what is the advisability of holding an investment in the company? As the shares will be held, the charity should ensure that the corporation will be viable. Thus holding companies are preferred to operating companies, with liquid investments preferred to illiquid. The company should not be cross guaranteeing. The charity should have the confidence that the company will not be stripped of its assets, by salary or dividend.
- 5) Liquidation- is there a plan for redeeming the shares. Should insurance be purchased in the company to back up the value of the shares and to ensure an ultimate redemption?
- 6) Dividends- how will they be paid? Are the shares cumulative? At what rate? Will the company be eligible for a dividend refund?
- 7) Disbursement quota- will the capital added to the charity and the dividends paid take care of quota responsibilities. Ensure that the donor makes a 10-year gift designation.
- 8) Valuation- given the tax effects is value important (if a FMV receipt will not be available or necessary then valuation is less important)? Otherwise valuation is key to a proper receipt. The act of valuation to support a value may lead to changes to the shares gifted, i.e. cumulative dividend feature added. Who will be engaged to perform the valuation? Who will pay for the valuation (the donor?)? See Richard Wise article.
- 9) Annual Audit- the charity's auditors will want to review annual financial statements of the company.

- 10) Professionals- Ensure the donor receives independent professional advice, an independent valuator engaged and the charity should consider receiving its own professional advise.
- 11) Resolution of the Board- as a consequence of the transfer of shares a Resolution of the Board or Executive should be made to accept the gift and allowing, say the Executive Director, to represent and sign on behalf of the charity.
- 12) Quebec Notary- Many lawyers hold that this form of gift should be notarized in Quebec.
- 13) Issue Receipt- The receipt should indicate the eligible amount of the gift (the fair market value of the shares), a description of the gift e.g. 10,000 Class A preferred shares of 78964 Canada Inc., name and address of the valuator and the actual date of the gift.

## **APPENDIX**

### **REVIEW OF TAX ISSUES SURROUNDING A REDEMPTION OF PREFERRED SHARES**

#### ***Some Terminology***

- 1) Adjusted Cost Base (“ACB”)- the amount that is paid for the shares;
- 2) Paid-up-capital (“PUC”)- sometimes called stated capital, the amount the company receives when it issues shares. This amount appears on the balance sheet.

A shareholder may acquire preferred shares of a company directly from another shareholder. If one shareholder sells these shares to another new shareholder then the company does not participate in the transaction. In this case the proceeds of disposition less his cost base would usually result in a capital gain. There is no effect in the company.

This is not the case if the company is buying back, redeeming the shares from the shareholder. In this case there are two potential tax results, interrelated, which could occur.

The first is a determination as to whether a taxable dividend results. The calculation is the redemption proceeds less the PUC of the shares. This dividend created is considered a taxable dividend paid by the company, which could make the company eligible for a dividend refund, and a taxable dividend received by the shareholder, subject to dividend tax credits if an individual or Canadian dividend tax treatment if a corporation.

The second determination is for capital gains. As the shareholder has disposed of the shares, has he realized a capital gain? This calculation is interrelated to the first one in order to avoid double taxation. So one takes the proceeds and reduce this amount by the deemed dividend computed first and then deducts the ACB of the shares to determine if a gain or loss results.

A reorganization of capital is a legal mechanism whereby a corporation effectively cancels some of its issued shares and replaces them with others. This reorganization, called Section 86 reorganization is

often used in estate freezes. If an individual owns the common shares of a company, which have grown substantially in value over time, he may wish to “freeze” the value to limit the amount subject to tax at death. So the corporation effects a section 86 reorg whereby the company cancels the common and exchanges them for equal value preferred. The company reissues common shares for nominal amounts to the children or a trust.

Say John started a company with \$100. He purchased 100 common shares for \$100. His ACB in the shares is \$100 and the PUC of the shares in the company is \$100- the company’s balance sheet evidences a line in shareholder’s equity of 100 common shares at \$100.

Five years later John sells the shares to Sam for \$5,000. He realizes a capital gain of \$4,900. The balance sheet of the company does not change. Sam grows the company and ten years later the company is worth \$ 2 million.

He wishes to effect an estate freeze. The company cancels his common and issues 2,000,000 Class A preferred shares, voting, redeemable for \$1 each. The company reissues 500 common shares to Sam’s 5 children for a total of \$500.

The balance sheet will now evidence 500 common shares for \$500 and 2,000,000 Class A preferred shares for \$100 (replaces the PUC of the original common). Sam’s preferred shares has an ACB of \$5,000 (the ACB of his common which was cancelled).

Sam wishes to have his preferred redeemed. The dividend is \$2,000,000 of proceeds less the PUC of \$100 or \$1,999,900. His proceeds of disposition of \$2m are reduced by the dividend of \$1,999,900 so his net proceeds are \$100. His ACB is \$5,000 so his capital loss is \$4,900. (Sometimes capital losses are denied in non-arm’s length situations- this must be checked.)