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Planned giving: Creative solutions to estate taxation issues

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This article illustrates the planning that can be achieved to accomplish a testator's charitable giving wishes, even though there are potentially non-liquid assets with a potential for adverse tax consequences. The authors had the opportunity to use the gift of privately held securities to facilitate the final wishes of a client. This article discusses the planning, decisions, and actions taken regarding his estate.

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. It is important to note that a gift does not qualify for a tax receipt unless it is accepted by the charity.

Summary of facts

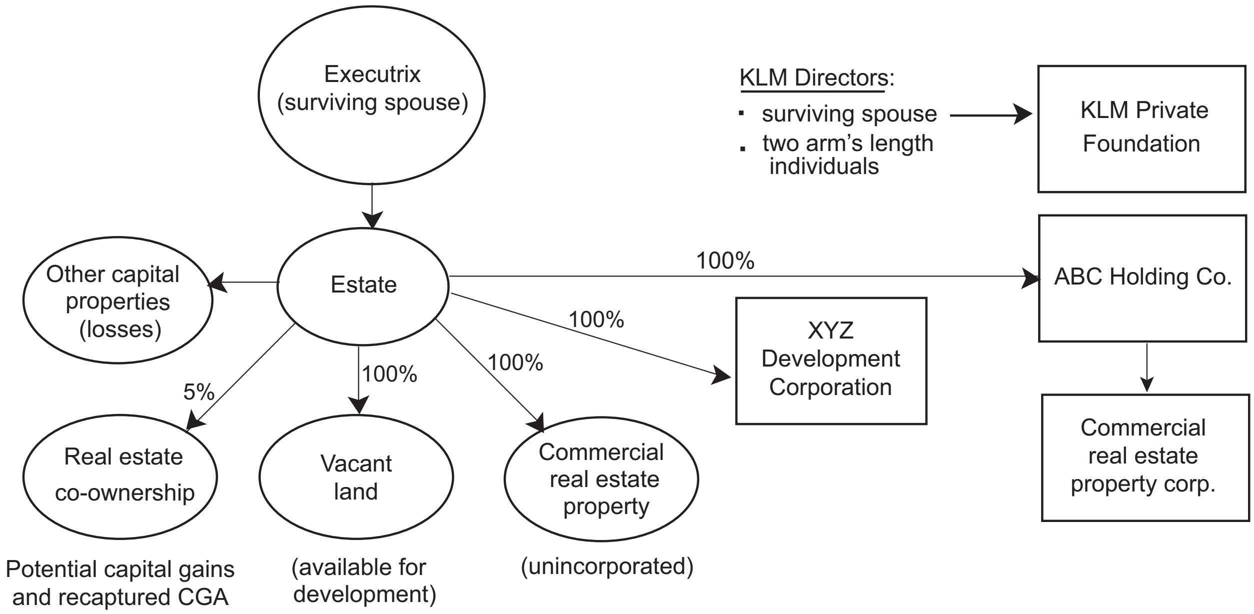
The testator passed away owning a significant amount of real estate. Ownership in real estate was held directly on an unincorporated basis, as an interest in a "co-ownership," and through incorporated companies. The testator was survived by his spouse. The will appointed the spouse as executrix and generally provided for an eventual transfer of all assets to the surviving spouse.

Many years earlier, the testator had established a Private Foundation — which we will call the KLM Foundation — for the purpose of undertaking certain charitable activities. The KLM Foundation had three directors, one of which included the testator's spouse. For income tax purposes, the Foundation dealt at "arm's length" with the surviving spouse and all of the corporations owned by the Estate.

The long-term charitable wishes of the testator were known to his surviving spouse and the other two directors of the Foundation. The intention was always to provide cash and liquidity for his surviving spouse, and eventually to transfer the real estate properties to, or for the benefit of, the private foundation, while minimizing estate taxes overall.

The following example is representative of the actual client and fact situation.

Organizational structure at date of death



Structural solution to address the testator's wishes

The shares of XYZ Development Corporation were gifted to KLM in order to provide a vehicle by which other investments could be acquired which would ultimately benefit the Foundation. This was done in accordance with the testator's wish. The vacant land owned by the Estate was sold to XYZ Development Corporation — now a subsidiary of the private foundation — at a price equal to the fair market value of the land. Consideration paid to the Estate consisted entirely of cash. The disposition would result in a capital gain to the Estate.

There were, however, other capital properties acquired by the Estate on death that had accrued capital losses. These properties would also be sold in the first taxation year of the Estate to crystallize these losses and these, in turn, were used to offset the capital gain triggered on the disposition of the vacant land. The net result was little or no tax created overall in the hands of the Estate. The sale of these assets, however, did generate a considerable amount of cash, which provided the liquidity sought by the testator for his surviving spouse.

The unincorporated commercial real estate property was then transferred to ABC Holding Co. pursuant to the tax-deferred provisions of subsection 85(1) of the Act. Consideration paid to the Estate for the commercial real estate property consisted of issuing a 4% interest bearing, demand promissory note to the Estate, the assumption of the outstanding mortgage on the property, and the issuance to the Estate of low paid-up-capital special preference (freeze) shares, with a "high" redemption value.

The common shares of the ABC Holding Company did not have a considerable value; therefore, they were gifted to KLM at their fair market value.

Further planning for the Estate provided for a sale of its interest in the real estate co-ownership for cash to an arm's length purchaser. The disposition of the Estate's interest in the real estate co-ownership would result in a capital gain and recaptured capital cost allowance.

For this reason, the sale was structured to occur at the beginning of the Estate's second taxation year — to take advantage of the progressive tax rate structure inherent for testamentary trusts. The timing was significant as it reduced the tax impact, which would otherwise have been realized by the surviving spouse at much higher tax rates.

The sale of the interest in the real estate co-ownership generated cash for the Estate, which would ultimately be distributed to the surviving spouse. Some of this cash was gifted by the Estate to the KLM Foundation as a simple, outright, unspecified gift. The Estate received a corresponding charitable tax credit, which helped to offset the tax otherwise exigible on the sale of the real estate co-ownership interest.

Overall, there was little or no tax payable by the Estate. The Foundation received cash from the sale of the co-ownership, while the residue of the cash was distributed by the Estate to the surviving spouse.

The Estate continued to hold the special preference freeze shares for the benefit of the surviving spouse. The special freeze shares are "dividend-bearing" and provide the Estate with a potential future cash flow. This structure provides that there will be sufficient cash flow to the Estate to provide liquidity for the benefit of the surviving spouse. The progressive tax rate structure in the spousal trust will continue to provide favourable tax treatment for dividend income received and taxed in the Estate tax return. The after-tax income can be distributed as capital to the surviving spouse.

There is also a continuing opportunity to realize on the value of the special freeze shares held by the Estate in a tax efficient manner, through a redemption or cancellation of the shares. The resulting "deemed dividend" on the redemption can be taxed within the Estate's progressive tax rate structure; this would be particularly attractive if there was no other income reported in the Estate for a particular taxation year.

The testamentary wishes of the surviving spouse provide for a gift of all or any remaining special preference freeze shares in ABC Holding Company to the KLM Foundation. While a deemed disposition of these shares will occur on death, the gift of the freeze shares to the Foundation will generate a charitable tax credit that will more than offset any resulting tax from the deemed disposition.

Concerns addressed from a gift perspective

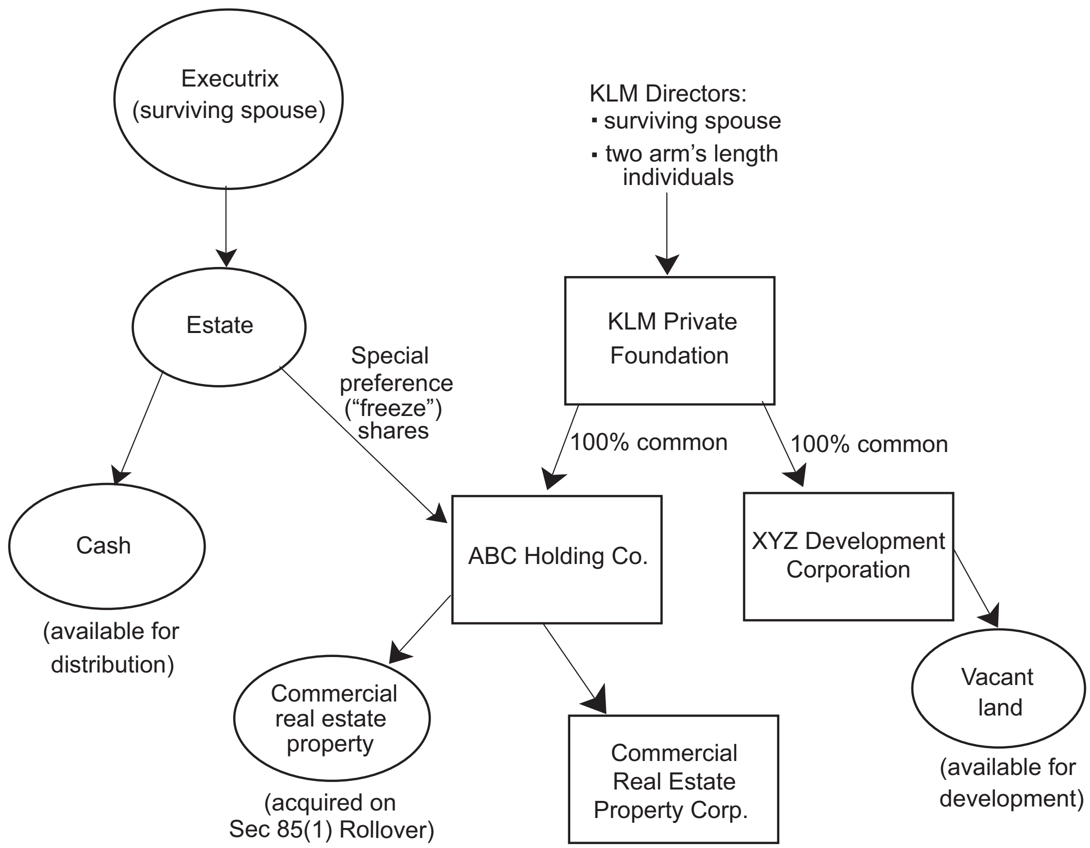
Foundations cannot actively acquire control of corporations (ITA 149.1(12)). However, foundations may acquire control by virtue of a gift. Therefore, the gifts of all the shares of both XYZ Development Corporation, and eventually ABC Holding Co., to the KLM Foundation did not jeopardize the registered status of the private foundation. Going forward, ABC Holdings Inc. or XYZ Development Corp. may need to acquire more real estate, resulting in acquisitions which may involve controlling other companies. Section 149.1(12)(a) states that a foundation is deemed to have acquired control of a corporation if it purchases (or provides some other consideration) more than 5% of the corporation. However, the foundation acquiring control of other corporations through ABC Holdings Inc. and XYZ Development Corp. is not contemplated in the Act.

Where there is a non-arm's length relationship between the donor and the issuing company, a serious issue can arise in respect of the acquisition of shares of a privately held corporation. These shares would be classified as a non-qualifying security under ITA 118.1(18). As such, they are not eligible for a tax receipt when gifted until certain situations occur; namely, the establishment of an arm's length relationship between the issuer and the donor or his estate (118.1(13)). However, by gifting 100% of the shares, the controlling interest, to the KLM Foundation, an arm's length relationship was established between the two companies and the estate of the testator. Therefore, a tax receipt could be issued for the **lower** of two values: the value on the date of the original gift, or the value on the date when the shares ceased to be non-qualifying.

Any time a charity issues a tax receipt for a gift, it is required to disburse 80% of the value of the receipt in the next fiscal year on its charitable activities (ITA 149.1). However, in this situation, KLM Foundation had no intention of selling the securities. Therefore, it needed relief from the disbursement quota. Such relief was found under ITA 149.1(b) through use of a ten-year direction. That section dictates that, when a donor indicates **in writing** that he or she directs the charity to hold the gift for a period of not less than ten years, the 80% requirement is deferred until the end of the ten-year period. Hence, charities can build endowment funds through the use of this mechanism.

Given that these problems were addressed, the organizational chart changed following the restructuring.

Organizational structure following the restructuring



In summary, the testator's wishes were fully realized as follows:

- All of the commercial real estate properties were effectively transferred to, or for the benefit of, the private foundation.
- The KLM Foundation will enjoy the future growth in the real estate in two ways:
  - through future appreciation, and
  - through debt reduction.
- The KLM Foundation has the structural means to make other real estate acquisitions through its subsidiary corporations.
- Liquidity was created for the surviving spouse.

- Income taxes were minimized by taking advantage of the tax rules relating to the use of a testamentary trust and by the timing of such dispositions and the realization of the estate assets.
- An "exit strategy" has been devised for the surviving spouse.

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