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## Gifts of Private Co Shares

Nicola · Wednesday, July 11th, 2012

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### Gifts (up to 75% of net revenue) may be made either by an operating or a holding company – the challenge is getting money out tax-effectively. Donations can often facilitate this.

Family businesses make up a great deal of wealth in Canada. However, often that wealth is illiquid and therefore difficult for entrepreneurs to access. Unlike publicly listed securities, gifts of private company shares do not enjoy the same favorable tax rules with regards to the tax on capital gains. In addition, there are rather complex rules surrounding the donation of private company shares (A.K.A. non-qualifying securities) to charity including:

- The Excepted Gift rules which permit a tax receipt to be issued for a gift of non-qualifying securities provided that the donor is at arm's length to the charity;
- In the absence of the gift qualifying under the Excepted Gift rules, the recipient charity cannot issue a tax receipt until the securities cease to be non-qualifying (e.g. the charity sells the securities). Furthermore, a tax receipt cannot be issued at all if the securities remain non-qualifying for longer than five years after the date of the gift. . Remember, five years may seem like a long time, but it can be difficult sometimes to find a willing buyer for private company shares;
- Thanks to a special reserve mechanism, the capital gain (if any) incurred at the time the non-qualifying security is gifted to the charity can be deferred for up to five years.

However, there are options for private business owners to donate shares from their company tax efficiently. Let's explore one of these.

### Refundable Dividend Tax on Hand (RDTOH)

The RDTOH is an important notional (not real) account on the books of Canadian private corporations . It has two important components: (1) a refundable portion of Part 1 tax on investment income (capital gains and interest only); and (2) a refundable portion of Part IV tax on taxable dividends received from unrelated companies.

So what is so important about the RDTOH account? When a private company pays out taxable dividends to its shareholders, it can claim a refund from the Canada Revenue Agency ("CRA") equal to one dollar for every three dollars of taxable dividendpaid. Generally speaking, the maximum amount that can be refunded in cash to the company is the balance of the RDTOH account.

Gifts from private companies are also often used as part of a company restructuring or wind down. If the company redeems the shares the proceeds received by the shareholder could be deemed a dividend subject to income tax. Therefore, in the right situation, redeemable preferred shares are a good way to make a gift because the valuation is relatively simple, and if the company has the cash, they can be readily redeemed (no need to hunt for a buyer).

## Example RDTOH

Bob has retired from his company some time ago. His tax advisors set up a trust to own the common shares, and he was issued fixed value preferred shares ("Estate Freeze Shares") that pay him an annual dividend. In this example, assume Bob's tax rate is 46%, the donation tax credit is also 46%, and the Estate Freeze Shares have a nil cost base and no paid up capital. In other words, the entire value of the shares will be a capital gain when disposed or gifted. Furthermore, the company has a balance in its RDTOH account and excess cash in the bank sufficient to redeem the shares if required.

Bob's wife had passed recently from a protracted battle with cancer. His wife was in and out of the hospital for years, and he was very grateful to the hospital staff that had worked so hard to help her. Bob arranges to gift $250,000 of his preferred shares in memory of his wife to the hospital for the benefit of the cancer ward. Given that Bob is at arm's length to the hospital, the sharesqualify as an excepted gift, hence he receives a $250,000 tax receipt immediately. Bob will have a taxable gain of $125,000 (50% of the capital gain) that will attract $57,500 in new taxes ($125,000 X 46%). The resulting tax credit saves Bob $57,500 in net tax savings ($115,000-$57,500 in tax).

The charity elects to redeem the shares promptly. The company pays out a $250,000 taxable deemed dividend to the charity (now a shareholder) for the shares. However, the charity pays no tax on the dividend, and the company receives the shares and a $83,250 dividend refund from CRA equal to 1/3 of the taxable dividend paid (assume the RDTOH account has sufficient balance).

## How public foundations can assist

A gift is a non-qualifying security when the donor is not at arm's length with the issuer of the shares (the company). Therefore, a tax receipt can only be issued when one of the following occurs: the security ceases to be non-qualifying because either the arm's length relationship to the issuer is broken (e.g. the charity sells (monetizes) the security), OR as in this example, if the security is a share. If the security is a share, a tax receipt can be issued once the donor is at arm's length with every officer, trustee, director or like official of the recipient public charity. In all three cases, there is a 60-month time frame from the date of the gift to accomplish the task. In all cases, the eligible amount equals the lesser of the original FMV on the date of the gift and the FMV or proceeds received at the later date.

**SPECIAL NOTE**: the excepted gift rules only work with public charities and not with private foundations.

*This article has been revised by Benefaction with permission from the author, DeWayne Osborn of Lawton Partners in Winnipeg.*

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