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Case Study: Capital Dividend Account

Nicola Elkins · Wednesday, December 8th, 2010

One of the best kept secrets: The Capital Dividend Account

Charitable Strategies for Donors with Holdco's

Adapted with permission from an article by JoAnne Ryan, VP Philanthropic Advisory Services, TD Waterhouse published in Gift Planning in Canada, October 2010

Donating securities can be a great way to save tax, but for clients who hold publicly-traded securities within an investment holding company there can be an even greater opportunity for making tax-efficient charitable donations. Many investment holding companies (Holdco's) own securities that have accumulated significant capital gains; and thereby may have large potential tax liabilities when those securities are sold. But, there are great tax savings opportunities for charitable shareholders. They could donate some of those securities now, during their lifetimes, on a highly tax-efficient basis AND make larger tax-free withdrawals. Ask your clients if they have securities in their corporations or sufficient pent up cash reserves with which to pay the tax free capital dividend. It could open up a whole new dialogue with a win/win result.

Let's start with the basics. There is no significant difference between the treatment of personal donations and the treatment of donations from investment Holdcos.

• There is no capital gains tax on appreciated securities that are donated to a registered charity, regardless of whether the donation is personal or corporate.

• When a corporation makes a donation, it receives a tax deduction. This deduction can be used to reduce taxable income and thereby tax payable. This differs from personal donations which receive a tax credit.

• The maximum claim that can be made in any given year is 75% of net income. Any excess can be carried forward for 5 years.

However, this picture changes considerably when we consider the role of the capital dividend account.

What is a Capital Dividend Account?

Every corporation has a ‘capital dividend account’ (CDA). It does not appear on a corporation’s balance sheet but it is often detailed in the notes to its financial statements. Many people think a CDA is a bank account. In fact, it is a notional account used to keep track of realized capital gains that are not subject to taxation – a whopping 50% of the total. The shareholder can withdraw this ‘non-taxable portion of the capital gain’ on a tax-free basis

.** Upon the death of the shareholder, no further withdrawals are possible.
** Assumes the CDA balance is nil before the transaction.

Example: CDAs and tax-efficient charitable donations

Let’s assume a charitable individual wishes to make a gift by donating appreciated publicly-traded securities from his investment Holdco. The shares have a fair market value (FMV) of $100,000 and a tax base of $0.

• If the Holdco sells the securities, half of the realized capital gain will be taxed as income. The other half flows to the Holdco’s CDA and may be subsequently withdrawn by the shareholder on a tax-free basis and donated to charity.

• Alternatively, the Holdco donates the securities to a charity, it will deduct $100,000 from income (thereby reducing taxes payable) AND avoid all capital gains tax because the securities were donated rather than sold.

But there is more: the Holdco can credit the non-taxable portion of a capital gain to its CDA. The FULL capital gain can now be added to a donor Holdco’s CDA.

In our example, this would allow the Holdco to bump up its CDA by $100,000, freeing even more funds for tax free withdrawal. Furthermore, if the shareholder does actually withdraw the additional $100,000 from the CDA, the value of the corporation will have effectively been reduced by $200,000 (the $100,000 share donation plus the additional $100,000 withdrawn tax-free from the CDA). When there is a deemed disposition of the Holdco shares, upon the death of the shareholder, his or her estate will enjoy a reduced tax bill. Lastly, the tax savings generated by the donation of securities may be used to purchase a life insurance policy on the shareholder with the corporation as the owner and irrevocable beneficiary. Upon the death of the shareholder the insurance payout will flow into the CDA. This amount can then be paid out, tax free, to the shareholder’s estate and subsequently to the heirs or charities.

Benefits to Clients with HoldCo's

1. The Holdco will receive a charitable tax receipt for the FMV of the securities.

2. The Holdco will pay no tax on the capital gains deemed to have been realized.

3. The full capital gains deemed to have been realized can be used to increase the value of the CDA, allowing for larger tax-free withdrawals from the Holdco.

4. Upon the death of the shareholder, his or her estate will pay less tax than would otherwise be the case. The value of the Holdco will have been reduced by the amount of the donation and any related tax-free withdrawals.

5. If an insurance policy is purchased, the proceeds will flow into the CDA upon the shareholder's death. These proceeds can then be distributed to the shareholders estate tax-free.

This entry was posted on Wednesday, December 8th, 2010 at 9:36 am and is filed under Advisors Corner, Dec 2010, Quarterly
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