The insured share donation strategy

Business owners have an opportunity to donate their private company shares to a registered charity using the insured share donation strategy, which may provide more tax and estate planning benefits compared to simply donating cash. Complex rules apply to this gift planning strategy, but with proper planning and professional advice it can be a tax efficient way to support a favorite charity.

How the strategy works

The insured share donation strategy is for business owners who both need permanent life insurance coverage and desire to make a significant charitable contribution as part of their estate plan.

The strategy works by the client's corporation purchasing a permanent life insurance policy on their life. Ideally the shareholder has done an estate freeze and, as a result, owns fixed-value preference shares having an easily ascertainable value.[1]

On death of the life insured, the corporate policyowner receives the insurance payout as beneficiary, and the estate donates the private company shares to a charity pursuant to the terms of the Will. The charitable donation will entitle the estate to a donation tax credit (DTC) which it may allocate to the terminal tax return.

The shares owned by the charity are subsequently redeemed by the corporation using the life insurance proceeds to pay the redemption price. This strategy requires coordination with the charity receiving the shares, so it's important to work with any arm's length charities which are intended to participate in the strategy.

Life insurance is central to the strategy

The pillar of this strategy is a corporately owned permanent life insurance policy. Corporate-owned life insurance presents a unique opportunity for business owners for several reasons:

- after-tax corporate dollars may be used to pay the premiums;
- a life insurance policy's cash value grows tax exempt within legislative limits;
- the insurance payout is received tax-free by the corporate beneficiary of the policy; and
- the amount of the insurance payout less the policy's adjusted cost basis (ACB), is added to the corporation's capital dividend account (CDA).[2]

Regarding the last point, this addition to the CDA generally allows for a corresponding tax-free distribution of corporate funds to Canadian resident shareholders. This same tax-free distribution cannot be achieved with other assets in a corporation because there's a tax cost associated with distributing these assets, by taxable dividends or salary to the corporation's shareholders. This strategy doesn't involve the corporate policyowner using CDA when paying the charity pursuant to redeeming its shares because a registered charity is exempt from income tax. As a result, the corporation doesn't need to use the CDA credit from the insurance, thereby preserving it for other corporate assets that'll be distributed to the GRE or surviving shareholders. This is a significant benefit of using this strategy.

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Example

Assume John, a business owner, has completed an estate freeze and owns fixed-value preference shares of a corporation ("Opco") having a nominal adjusted cost base and a fair market value of $10 million. John's daughter is involved in the business and will take over Opco when he retires. With no planning in place, John could have a $2.5 million tax liability at death, assuming a 50% marginal tax rate.[3] Alternatively, if John has a charitable objective, he could use the insured share donation strategy in his estate plan in the following way:

1. Opco purchases a permanent life insurance policy on John's life with a $5 million death benefit. The corporation is the beneficiary and the premium payor. The availability of both the insurance coverage and the amount of coverage available is subject to underwriting.

2. On death, John's estate (a graduated rate estate, discussed below) donates half of his preference shares of Opco ($5 million value) to the charity or foundation designated in his Will. Assuming a DTC rate of 50%, the donation results in a tax credit of approximately $2.5 million, which may be allocated to John's terminal return and used to eliminate the capital gains tax at death of $2.5 million.

3. Opco receives the $5 million insurance payout and, assuming the policy's ACB is nil, receives a corresponding $5 million CDA credit.

4. Opco redeems the preference shares held by the charity and pays the redemption price of $5 million using the life insurance proceeds.

5. As noted, Opco does not use its CDA when paying the redemption price because a charity is a tax-exempt entity and is not subject to tax on the payment. As a result, Opco has $5 million of CDA available that could be used to distribute $5 million of retained earnings to the daughter going forward.

The results with respect to this strategy are as follows:

- John obtains permanent life insurance coverage.
- A DTC is available in connection with the donation of the preferred shares which can be used to offset all the taxes otherwise payable by the estate arising from John's capital gain on death ($2.5 million).
- Upon the redemption of the preference shares, the charity receives a $5 million deemed dividend. However, as the charity is tax-exempt, there is no tax payable.[4]
- Opco's CDA is increased because of the receipt of the life insurance proceeds by an amount equal to the insurance payout minus the policy's ACB. As such, the client's daughter may be able to extract $5 million of retained earnings from the corporation, tax-free.

The table below summarizes the strategy's benefit to both the terminal return, daughter and the charity:

Capital gains tax in terminal return (after DTC allocate)	$0
Funds received by the charity	$5,000,000
Potential tax savings to daughter from unused CDA ($5 million * dividend tax rate of 44%)	$2,200,000

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Donation tax rules

The designation of an estate as a "graduated rate estate" (GRE) is particularly important in the context of this strategy because the estate will likely seek to allocate the donation tax credit (DTC) generated from the donation to the deceased's terminal return. An estate may not make this allocation unless it's designated as a GRE. Also, for the purposes of this allocation, the estate generally has 60 months from the date of death to make the donation.

Generally, once the donation is made the DTC may be allocated to:

- The deceased – for the year of death and the preceding year (i.e., last two taxation years).
- The GRE – for the year in which the donation is made and its previous taxation years, if any.

Any unused balance can be carried forward by the GRE to offset income tax payable in its next five taxation years, up to 75% of its net income. Generally, your ability to claim a donation tax credit is limited to 75 per cent of your net income for the year. For donations made by Will (or by beneficiary designation), this annual limit is increased to 100% of net income in the year of death and the preceding year.

It's important that shares of the corporation are donated rather than the GRE receiving a cash dividend from the estate (using the insurance proceeds) and then donating the funds to the charity. Charitable donations from a GRE that may be allocated to the terminal return are restricted to those donations that are: 1) gifts that are deemed to be made by the estate (e.g. via beneficiary designation from a policy owned by the deceased) or 2) gifts of property acquired by the GRE "as a consequence of death" of an individual or "property that was substituted for that property."[5] The latter restriction encompasses a cash dividend (taxable or capital) that distributes life insurance proceeds from a corporation, because the dividend isn't property received by the GRE as a consequence of death. As a result, gifting shares of the corporation addresses this issue as the shares are acquired by the GRE as a consequence of death.

Considerations for private foundations

A client's GRE may donate the private company shares to a public foundation, private foundation, or registered charity. This strategy works particularly well with private foundations since it requires coordination between the estate and the charity. When private foundations are involved in this strategy, additional rules affect when the DTC is available to the GRE despite having gifted the shares. Unlike public foundations and registered charities, private foundations can only issue donation tax receipts once the donated shares are disposed of through the redemption and cash proceeds from the redemption are received.[6] As such, the corporate-owned life insurance is crucial to this strategy as it provides the liquidity upon death needed to redeem the donated shares.

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[1] A valuation of the donated private company shares may be required to determine the amount of the donation if the donated shares are common shares.
[2] The credit to the CDA in respect of a receipt of life insurance proceeds is calculated pursuant to paragraph (d) of the definition of "capital dividend account" in subsection 89(1) of the *Income Tax Act* (Canada) ("ITA").
[3] Pursuant to paragraph 70(5)(a) of the ITA, the shareholder is deemed to have disposed of their shares immediately before death and to have received proceeds of disposition equal to the fair market value of such shares.
[4] A registered charity (including public and private foundations) is exempt from taxation pursuant to paragraph 149(1)(f) of the ITA.
[5] Subsection 118.1(5) of the ITA.
[6] Paragraph 118.1(13)(c) of ITA.

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