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Special Circumstances

The nuances of proposed capital gains exemption for charitable giving

In the April 21, 2015 federal budget, the Department of Finance announced proposals to provide an exemption from capital gains tax with respect to certain dispositions of private corporation shares or real estate where a gift is subsequently made to a registered charity. The draft legislation giving effect to these proposals was released on July 31, 2015, with a consultation period ending last month. Let's consider these new rules and some possible impacts on buy–sell arrangements that are funded with corporate or individually owned life insurance.

The draft legislation provides an exemption from capital gains tax under the following circumstances:

- the taxpayer disposes of shares in a private corporation or real estate situated in Canada after 2016;
- the disposition is to an arm's length purchaser;
- cash proceeds have been gifted to a registered charity not more than 30 days after the disposition of the property; and
- the taxpayer is a resident in Canada at the end of the taxation year of the disposition.

This will result in the taxpayer not only benefiting from the charitable donation tax credit arising from the gift, but also a reduction in the capital gains tax that would otherwise arise on the disposition.

There is a special rule that provides an exemption from capital gains tax arising on the deemed disposition of shares in a private corporation or real estate in Canada due to the death of the taxpayer. In this case, if the graduated rate estate of the deceased taxpayer disposes of the property to an arm's-length purchaser and makes a qualifying gift to a registered charity not more than 30 days after the disposition of the property, a portion of the exemption that would otherwise be available to the estate may be utilized in the deceased's terminal return. In this situation, the deceased must be a resident in Canada immediately before death to qualify.

Four important planning points arise from the application of these criteria:

- The gift must consist of money. In other words, debt received on the sale cannot be the subject of the gift to the qualified done.
- The gift of money must be made within 30 days of disposition to the third party. This condition may be difficult to satisfy as the cash proceeds may not be advanced within a 30-day period after closing due to escrow arrangements, undertakings, post-closing adjustments, or the need to satisfy other post-closing conditions.
- The ability to use the exemption in the terminal return of a deceased taxpayer is dependent on his or her estate qualifying as a "graduated rate estate," which, among other conditions, means the sale of the property and gift must take place within three years of death.
- The exemption does not appear to be available where the taxpayer has disposed of the property and dies in the same taxation year (with a cash gift either being made in that year or contemplated to be made by the taxpayer's estate).

The draft legislation provides a formula for determining the amount of the capital gains tax exemption, which is based on the amount of the capital gain arising on the disposition, the size of the cash gift, and the total proceeds of disposition. Generally speaking, the exemption will be no greater than the amount of the cash gift, and in many cases will be pro-rated to be a lower amount.

The draft legislation also contains a number of rules that will either deny the ability of the taxpayer to claim the exemption, or will claw back the exemption if certain transactions involving non-arm's-length persons take place within 60 months after the disposition of the property. These rules are extremely broad and complex, and represent a trap for the unwary.

As for the impact of these rules on insured share purchase agreements, consider these preliminary observations.

1. The estate may be dealing at arm's length with the surviving shareholder(s), but not with the corporation. This could influence whether the buy–sell arrangement should be completed by way of share redemption and/or through a cross-purchase arrangement.

2. As noted, the gift to the registered charity has to be in the form of cash within 30 days after the disposition of the shares. Having life insurance in place to fund the buyout may therefore ensure cash is available within the applicable 30-day period. Because the donation must be in relation to cash proceeds received, traditional promissory note method buy–sells may not allow for the exemption to arise.

3. The formula for determining the exemption amount may not operate properly where there is a share redemption strategy, and will be one of the issues CALU plans to discuss with the Department of Finance.

While the proposed exemption is a welcome development that should encourage additional charitable gifting, it has also resulted in the introduction of anti-avoidance rules that could create adverse tax consequences for the taxpayer who benefited from the exemption, or for certain non-arm's-length persons. F

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