Donation of private corporation shares and real estate – new Canadian legislative proposals released

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A number of years ago, the government introduced legislation (under paragraph 38(a.1) of the *Income Tax Act – the "Act")* that exempts from taxation realized capital gains when publicly traded securities are gifted directly to registered charities. Subsequent to the introduction of such rules, many commentators have suggested that donations to charities from proceeds realized upon the disposition of real estate and private corporation shares should also be subject to a similar capital gains exception. The government has resisted introducing such measures until the 2015 Federal Budget (the "Budget") which was released on April 21, 2015.

The Budget proposed to exempt from capital gains tax certain dispositions of private corporation shares and real estate occurring after 2016. As discussed in our firm's Budget blog, it was revealed that the exemption will be available where:

1. cash proceeds from the disposition of the private corporation shares or real estate are donated to a qualified donee within 30 days after the disposition; and
2. the private corporation shares or real estate are sold to a purchaser that is dealing at arm's length with both the donor and the qualified donee to which cash proceeds are donated.

The exempt portion of the capital gain will be determined by reference to the proportion that the cash proceeds donated is of the total proceeds from the disposition of the shares or real estate.

The Budget also announced that anti-avoidance rules would be drafted to ensure that the exemption is not available in circumstances where, within five years after the disposition:

1. the donor (or a person not dealing at arm's length with the donor) directly or indirectly reacquires any property that had been sold;
2. in the case of shares, the donor (or a person not dealing at arm's length with the donor) acquires shares substituted for the shares that had been sold; or
3. in the case of shares, the shares of a corporation that had been sold are redeemed and the donor does not deal at arm's length with the corporation at the time of the redemption.

A simple example can help illustrate the intent of the new rules. Consider the situation of Ms. Apple, a Canadian resident for income tax purposes. Ms. Apple is the sole owner of a piece of Canadian real estate. Such real estate was bought by Ms. Apple many years ago and has appreciated greatly in value. Let's assume that there is an unrealized gain of $1M associated with the real estate while the fair market value of the property is $2.5M. There is no debt associated with the property. Ms. Apple is philanthropic and, as part of her estate planning, she intends to sell the real estate and donate the realized funds in 2017 to her favorite charity – XYZ Canadian Charity. Ms. Apple deals at arm's length with XYZ.

In the absence of the new rules, Ms. Apple would sell the property, realize a capital gain of $1M on the

sale and, depending on the province where she is resident, would pay income tax of approximately $250,000 as a result of such a capital gain. Of course, Ms. Apple would receive a charitable receipt of $2,250,000 ($2.5M proceeds less the income taxes payable of $250,000) from XYZ upon the subsequent donation of the cash to XYZ which she could use to offset the income taxes payable. However, as you can see, the benefit of the gift is ultimately reduced by the income taxes payable[1].

With the new proposals, Ms. Apple could sell the property (to an arm's length party) and ensure the cash proceeds are donated to XYZ within 30 days after the disposition. In that case, the capital gain on the sale would be nil and Ms. Apple would receive a charitable receipt for the full amount of the sale proceeds. The result is that the gift is not reduced by any income taxes payable.

On July 31, 2015, the Department of Finance released a package of technical tax amendments. The draft legislation to implement the above-noted Budget proposals was included in the package. (As an aside, recall that July 31, 2015, was the Friday of the long weekend for most Canadians. The Department of Finance has a long history of releasing draft tax legislation on the Friday of long weekends. Lo and behold, the tradition continued! For those of you who know me well, you'll know that I was truly excited to receive the package… an exciting long weekend of reviewing draft legislation laid ahead!! I love those crazy guys and gals at the Department of Finance!)

For the most part, the draft legislation seems to implement all of the Budget proposals related to the new measure. It does so by introducing a number of new provisions into the Act. Reading these new provisions will be a challenge to any inexperienced tax person. The draft legislation contains the promised anti-avoidance rules in new subsections 38.4(2) – (4) and paragraph 38.4(1)(c) of the Act. Such provisions are very broadly drafted. Obviously the Department is concerned with any possible planning mischief that might occur to frustrate the intended favorable tax policy. The Explanatory Notes released with the draft legislation contain the following statement:

> *While these amendments include a number of provisions to address several potential issues that could otherwise result in unintended and undesirable effects from a tax policy perspective, concerns remain in relation to the potential use of this measure to obtain unintended tax benefits, beyond the scope of the targeted incentive. The government will continue to monitor the effectiveness of the measure and take appropriate action to address such tax planning, as required.*

This is not the first time the Department has warned that there could be further tightening of the rules to prevent unintended mischief. For example, when the so-called "kiddie-tax" rules – under section 120.4 – were introduced in the 1999 Budget to shut down certain types of income splitting with minor children, the Department made the following statement in its Budget materials:

> *The scope of this new measure is narrow; it targets those structures that are primarily put in place to facilitate income splitting with minors. The government will monitor the effectiveness of this targeted measure, and may take appropriate action if new income-splitting techniques develop.*

True to their word, the Department has, over the years, introduced a number of new "kiddie-tax" amendments to further target certain income splitting plans that were developed to by-pass such rules. The most recent amendment arose out of the 2014 Federal Budget. Accordingly, it would not surprise any good tax professional if the Department remained true to its word with respect to the new anti-

avoidance rule promise and ultimately introduces legislative “fixes” to shut down any clever tax planning that may arise as a result of the new proposals. Accordingly, my brothers, sisters and I in the tax profession may need to restrain ourselves when attending tax parties where brainstorming (and other activities) occurs to try to overcome these nasty anti-avoidance rules.

The Department of Finance has asked for comments to be provided on the draft legislative proposals by September 30, 2015. It is likely that the CBA/CPA Canada Joint Committee on Taxation will have comments submitted by the deadline. Accordingly, stand by for detailed comments. In the meantime, shareholders of private corporations or owners of Canadian real property who may have philanthropic objectives and a monetization event with respect to their shares or real estate may wish to start familiarizing themselves with the new rules that will have application in 2017 and onward.

A final caution: to the extent the Canadian resident person who wishes to take advantage of these new rules is a US citizen/person, such individual also needs to be in compliance with US tax law. It is highly likely that the new Canadian proposals do not “fit nicely” with US tax law.

1. There are other requirements under the Act for claiming a charitable tax credit such as certain income restrictions. For illustrative purposes, we assume that Ms. Apple meets all of the requirements.