

## The Donation of Private Corporation Shares and the Insured Share Donation Strategy

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Business owners may want to donate some of their private corporation shares as a part of their estate plans. This can help philanthropic business owners make a significant gift to charities of their choice without depleting any inheritances for their loved ones. However, the recent decision of [\*Odette v. The Queen\*](#)<sup>1</sup> demonstrates what happens when a donation of shares is not structured properly. As explained below, the taxpayer's transactions fell within the "non-qualifying securities" (NQS) rules of the *Income Tax Act*.<sup>2</sup> As such, the Tax Court of Canada (TCC) denied the \$17.7 million donation tax credit that the taxpayer's estate claimed for the donation it had made to the deceased's private foundation. The first part of this article discusses *Odette*. The second part explains the "insured share donation strategy" and how corporate-owned life insurance can help make the gift of the shares eligible for a charitable donation tax credit.

### Facts

Mr. Edmond G. Odette (Mr. Odette), a well-known philanthropist, passed away on November 17, 2012. His estate implemented a tax plan with these steps:

- On December 20, 2013, the estate gifted \$17.7 million of Mr. Odette's private company shares of Edmette Holdings Ltd. (PrivCo) to the family's private foundation, the E. & G. Odette Foundation (the Foundation).

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<sup>1</sup> 2021 TCC 65 (*Odette*).

<sup>2</sup> R.S.C., 1985, c. 1 (5th Supp.) (ITA).

- On December 23, 2013, PrivCo bought the shares back from the Foundation in exchange for a non-interest bearing promissory note in the principal amount of \$17.7 million.
- The Foundation issued PrivCo a charitable donation tax receipt dated December 23, 2013, for \$17.7 million.
- On May 17, 2013, the estate filed its terminal tax return for the 2012 tax year. It claimed a charitable donation tax credit for the \$17.7 million donation.
- In 2014, PrivCo paid off the promissory note with cash in three installments, the final one on August 6, 2014.

In 2016, the Canada Revenue Agency (CRA) assessed the estate and disallowed the \$17.7 million charitable donation tax credit. The estate appealed to the TCC. The only issue before the court was whether the estate was entitled to the \$17.7 million charitable donation tax credit for Mr. Odette's 2012 terminal tax return.

### **NQS Rules**

An NQS is defined generally as a share, debt obligation, or other security issued by a donor or a person not dealing at arm's length with the donor.<sup>3</sup> For example, a business owner's shares of a private company would be an NQS. They are not easily liquidated and generally not available for sale in the public markets (that is, stock exchanges).

When NQS are donated to a private foundation, the ITA deems the gift to have taken place when:

- the foundation sells the shares within 60 months, or
- the shares cease to be an NQS.

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<sup>3</sup> ITA subsection 118.1(18).

When the charity disposes of the NQS, the value of the charitable gift of an NQS is deemed to be the lesser of:<sup>4</sup>

- the fair market value of any consideration (other than the NQS) received by the donee (in this case, the private foundation)
- the fair market value of the security.

Put simply, if a gift is a non-qualifying security, the ITA deems the gift's value to be nil. Therefore, as the TCC found in this case, the charitable donation tax credit would be denied. These rules do not apply if the charity is a public foundation or charitable organization with which the donor deals at arm's length.<sup>5</sup>

### **TCC Decision**

The estate argued that "any consideration" includes both the promissory note and the cash payments made to pay off the corresponding note. The TCC disagreed stating that the consideration must be *received* at the time of the disposition of the shares – and what was received was a promissory note. Because the promissory note was between non-arm's length parties, it was *also* an NQS. Thus, the relevant section of the ITA deems the fair market value of the PrivCo shares to be nil. As such, Mr. Odette's estate was not entitled to the \$17.7 million charitable donation tax credit.

Further, for tax policy reasons, the TCC stated that Parliament does not want to grant a donation tax credit where the donor is not impoverished and the charity is not enriched. In the court's opinion, a non-arm's length promissory note creates no real obligation to pay and is unconvincing. Non-arm's length parties can artificially enter into similar transactions, claim a donation tax credit and never

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<sup>4</sup> ITA paragraph 118.1(13)(c).

<sup>5</sup> ITA paragraph 118.1(19).

actually make payments. For this reason, it is important to show that the donor is in fact impoverished and the charity is actually enriched.

However, it is important to note that in the final result the estate in fact was impoverished because it actually paid off the promissory note, and the charity was enriched because it did in fact receive the donation in cash. Viewed in this light, the decision may seem harsh. Still, the TCC's concerns are important. The strategy did not result in the charity receiving any property it could use until after the estate had:

- paid off the promissory note
- received its donation tax receipt, and
- claimed a tax credit.

The timing of these events was perhaps not in line with what Parliament had intended.

The TCC also emphasized that legal form matters. The court found that the transfer of the PrivCo shares, and the promissory note were part of a plan to:

- maximize charitable donations and claim a credit for the donation, and
- make the actual cash payment once the funds were available to do so.

The court concluded that the estate's plan failed because it did not respect the NQS rules of the ITA.<sup>6</sup>

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<sup>6</sup> See also *Remai v. The Queen*, 2009 FCA 340 where the court found that the NQS rules and the ITA's general anti-avoidance rule did not apply when the taxpayer gifted \$15 million of promissory notes (face value) issued by his company to his family private foundation. The foundation later sold the notes to a company controlled by the taxpayer's nephew, which the court found at arm's length with the taxpayer. The tax result was that the gift was eligible for a charitable donation tax credit.



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### **Key takeaway**

The result in *Odette* could have been avoided if there was corporate-owned life insurance to redeem the gifted shares. Since the share redemption proceeds is the consideration received for the share redemption, the NQS rules would not have applied. Thus, the \$17.7 million gift could have been claimed in Mr. Odette's terminal return. Using life insurance with a gift of private donation shares is commonly referred to as the "insured share donation strategy". For more information on the insured share donation strategy, please read on.

## **The Insured Share Donation Strategy – Another Planned Giving Opportunity**

An effective way to structure a charitable donation of private company shares is to employ the “insured share donation strategy.” This strategy can allow business owners to meet their philanthropic goals while providing many tax benefits.

### **Client Profile**

The insured share donation strategy is ideal for the philanthropic business owner who:

- has a holding company (PrivCo)
- has possibly completed an estate freeze
- owns preferred shares (although this strategy will work with common shares as well), and
- has a private foundation (or plans to establish one).

### **How It Works:**

#### **Step 1: Purchase of life insurance policy and gift of shares in Will**

- PrivCo buys a permanent cash value life insurance policy on the life of the shareholder/business owner and is the policy's owner and beneficiary.
- The business owner's Will is updated to gift some of the shares to his/her private foundation at death.
- The private foundation and PrivCo enter into a written agreement. This agreement says that PrivCo will buy back the donated shares from the private foundation using the life insurance proceeds it receives when the business owner dies.

**Step 2: Gift of shares**

- After the business owner's death, the shares are deemed to be disposed of at fair market value. Thus, the estate will have to pay capital gains tax.<sup>7</sup>
- The death benefit is paid to PrivCo on a tax-free basis.
- The business owner's estate donates the shares to the private foundation as stated in the Will.

**Step 3: Corporate redemption**

- PrivCo redeems the shares from the private foundation. This must be done within 60 months of the date the shares were donated in order to claim a charitable donation tax credit.
- PrivCo uses the life insurance proceeds to fund the redemption.

**Step 4: Claiming the charitable donation tax credit**

- The estate claims the charitable donation tax credit based on the fair market value of the redemption proceeds.

**Tax advantages and consequences**

- While alive, the business owner's investment component of the life insurance policy grows tax-free.
- When the life insurance proceeds are paid to PrivCo, PrivCo's capital dividend account (CDA) is increased by the death benefit proceeds less the adjusted cost basis of the policy.
- A CDA is created where money can be paid out to the business owner's children and/or grandchildren on a tax-free basis.

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<sup>7</sup> ITA subsection 70(5).

- PrivCo declares the dividend on the redemption to be a taxable dividend. Therefore, the dividend does not reduce the corporation's CDA (even though the money used to pay this redemption dividend came from a life insurance policy death benefit). Since the private foundation is a tax-exempt entity, it does not pay dividend tax on the redemption of the shares.
- As mentioned above, upon the death of the business owner, capital gains taxes will apply on the shares. However, federal and provincial charitable donation tax credits will offset the capital gains taxes on the shares.
- The business owner has created a valuable charitable legacy.

As with any estate plan, there are tax risks that need to be addressed with the Clients' tax professionals. Once these risks are managed, the insured share donation strategy can be an excellent planned giving opportunity for the philanthropic business owner who seeks to leave a legacy in a tax-efficient manner.

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