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e-brief

September 15, 2009

THE CHARITIES PAPERS

Unlocking More Wealth: How to Improve Federal Tax Policy for Canadian Charities

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- The landscape of charitable giving in Canada has been altered over the past decade by tax incentives favoring large gifts of capital. Next steps could include tax credits for donations of real estate assets and private company shares.
- This policy reform promises to increase charitable giving, broaden the donation base and make charities less vulnerable to market swings.
- These credits can be introduced in a manner consistent with existing laws that reduces the chance of tax system abuse.

Since 1996, successive federal governments in Canada have introduced more than 20 tax incentives to encourage and regulate charitable gifts of capital. These measures include increases to contribution limits,[1] direct designation rules for registered retirement funds and life insurance, and a series of incentives that eliminate capital gains on gifts of public securities and related assets. But what has been the cumulative impact of these measures on the charitable sector? And how can tax policy for charities be further improved for the benefit of Canadians?

The Changing Landscape of Giving

Together, the incentives support occasional extraordinary gifts of capital rather than increased annual giving from income. The introduction of these changes coincided with unprecedented increases in charitable giving. Tax receipted charitable giving has grown by 140 percent, from $3.60 billion in 1995 to $8.65 billion in 2007.[2]

However, there has also been an accompanying shift in the landscape of giving, with a trend to fewer donors giving larger gifts. The number of taxpayers reporting donations on their tax returns has been declining for more than a decade. Anecdotally, charities have reported an increase in gifts in excess of $50,000, as the charitable giving incentives are integrated into the personal planning process. The biggest increase in giving has come from taxpayers with incomes in excess of $85,500. Total contributions for this group increased more than 220

1 Contribution limits increased from 20 percent to 75 percent of income per annum and 100 percent at death.

2 Statistics Canada does not break out giving data by type of asset or timing (i.e., gifts by will or life insurance). The absence of detailed tax data makes it difficult to state definitively the relative importance of capital tax incentives on giving. The sharp rise in giving is coincident with introduction of tax incentives. Wages and income grew by 87.5 percent from 1995 to 2007 versus 140 percent for donations. [CANSIM Table 380-0016]. In the two decades prior to 1996, giving tracked wages. Other factors affecting giving may include capital market growth, real estate values, lower tax rates, changing philanthropic attitudes, more fundraising, and increased concentration of wealth.

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percent, or approximately $800 million, from 1991 to 2006, and increased significantly after the complete elimination of capital gains tax on gifts of securities in 2006 (Payne. Forthcoming). It is possible, too, that some of the new incentives have created an overdependence, among some charities, on certain type of gifts.

But how do we calculate the incentives' overall effectiveness? As we have seen, they have focused on removing barriers to the giving of capital property, through the elimination of capital gains taxation and by reducing administrative hurdles for claiming gifts. The effectiveness of such incentives depends, in part, on their success in encouraging greater giving and increasing the net public benefit.

The offsetting factor is foregone tax revenue, which could otherwise be used to finance direct program spending. The incremental cost to government in excess of the basic tax credit is tied to the capital gain tax, which varies depending on the adjusted cost base of the property. The extra tax incentive is never greater than the capital gain tax rate, which is 50 percent of the normal marginal tax rate.

The Rationales for Tax Policy Changes

Although the existing regime, by promoting gifts of capital, has been successful in increasing the value of donations to registered charities, it has some limitations.

1. The number of taxpayers claiming donations has declined, despite the overall increase in the value of donations. In 1990, 30 percent of tax filers claimed donations; in 2007, the number was 24 percent. Charitable groups are concerned about erosion of the donor base and a growing concentration of giving directed to large charities. Incentives for capital gifts support growth in the overall value of donations, but do not address the number of Canadians who donate or guarantee broad distribution among registered charities.

2. The elimination of capital gains on gifts of public securities has created imbalances in the tax system. There are two remaining major asset classes not eligible for the capital gains exemption: private company shares and taxable real estate. This leads to a situation where a casual investor who donates public stock would not pay capital gains tax, while a founder of a 25-year-old private business who donates stock would face a tax bill. As a result, these two categories of assets, which are worth approximately twice the $1.3 trillion market capitalization of two major Canadian public markets,[3] are rarely donated.

3. Donations of public securities are market sensitive, hence individual charities reported declines in these donations of up to 80 percent in 2008. As the need for services increases during downturns, charities are especially vulnerable to revenue declines owing to an over dependence on a single class of assets.

Further Policy Options for Donations of Capital

Capital incentives increase the overall value of assets contributed to registered charities, although the distribution is skewed to larger charities, such as universities, hospitals, national charities, and foundations. Donations of taxable real estate and private company shares are the two primary candidates for similar treatment to that accorded gifts of public securities.

There are nevertheless practical challenges for policymakers and for charities that must be overcome. Donations of private company shares are highly regulated within the *Income Tax Act* to reduce inappropriate non-arm's length transactions and valuation abuses. Federal officials have expressed concerns about determining fair market value for gifts of taxable real estate. As well, real estate presents additional complexity and liability for charities, such as environmental issues, maintenance and property taxes.

3 This figure represents issuer market capitalization on the Toronto Stock Exchange and the TSX Venture Exchange as of December 31, 2008.

It is clear that valuation and charity management issues are integral to the discussion of new incentives. Fortunately, precedents exist within the *Income Tax Act* to make the elimination of capital gain taxation for real estate and private company shares a viable option.

Gifts of Taxable Real Estate

Taxable real estate includes vacation, industrial, commercial, and residential investment properties, but excludes principal residences, which are tax exempt. There are two scenarios where charities receive real estate: i) donations where the real estate is sold and the proceeds used to fund the charity's mission; ii) in-kind donations where the real estate is retained to advance the charity's mission.

(i) Donations of Cash Proceeds of a Real Estate Sale

Since 2000, the *Income Tax Act* has enabled donors to sell certain, narrowly defined property[4] to fund a donation – and to eliminate tax on disposition – if the property is donated within a certain period of time. The attribution mechanism is efficient because it provides valuation certainty for tax purposes, and simple management for charities, which reduces costs and increases public benefit. This precedent could be applied more broadly to include donations of real estate, both for lifetime gifts and gifts by will. After selling the property, the donor could donate part or all of the cash proceeds to a charity within 30 days. The donation would eliminate the capital gains tax on the sale, as well as provide the usual credit or deduction.

The provision enables taxpayers to donate all or part of the net proceeds of the sale, which enables tax treatment of the overall transaction to be prorated. If the provision were extended to real estate, proceeds from the sale could be divided and used to make a donation, settle a mortgage, or for personal purposes. Only the donated portion would count against taxable capital gains. The official receipt would be based on the cash received by the charity, which would remove valuation risk. The charity would be freed from managing mortgages, the cost of transfer, and other liabilities associated with property management.

(ii) In-Kind, Mission-Related Real Estate Donations

A taxpayer willing to make a gift of real estate for use by a charity should not be effectively penalized by the introduction of a new tax incentive favouring cash proceeds of real estate. However, clear rules are required to prevent abuses that might be caused by increased tax benefits. These rules would be consistent with some existing provincial legislation, such as the *Charities Accounting Act* in Ontario.

For an in-kind donation of real estate to qualify for the elimination of capital gains tax, the qualified recipient would need to hold the real estate for a minimum of 10 years and use it directly for charitable purposes. A valuation by a qualified independent appraiser would be required to substantiate the receipt. An intermediate sanction, similar to the existing 105 percent penalty for issuing false receipts, could be applied to the registered charity if the property was sold within 10 years. The 10-year hold period would reduce valuation concerns by ensuring only donations for mission purposes could be supported by an independent valuation.

There is another potential complication to take into account. The disposition of real estate may trigger recapture of capital cost allowance (CCA), which is 100 percent taxable. This is because depreciable real estate assets will have generated CCA deductions on taxpayers' prior years' returns. Tax rules require that these deductions be added back in calculating the taxable capital gain on disposition; recapture of CCA can be a major cost to the taxpayer. However, the ability to forgo CCA recapture, as well as to eliminate capital gains tax on the property, could be viewed as providing to taxpayers an excessive benefit from real property donations. On the other hand, the tax credit (or tax deduction if the donor is a corporation) from the gift would more than offset the cost of CCA recapture. Hence, it is unlikely taxpayers with charitable intent would be discouraged from giving, even if CCA recapture was retained.

4 Net proceeds from the sale of public securities acquired through employee stock option plans; *ITA* s. 110(2.1).

Gifts of Private Company Shares

Provisions in the *Income Tax Act* define private company shares as non-qualifying securities in terms of the donor's relationship to the charity.[5] If a donor is not at arm's length from the charity, then no receipt may be issued until the security is disposed of by the charity within 60 months of the donation. To provide valuation certainty, the receipt is based on the cash received by the charity, not the value of the securities at time of transfer. These provisions pertain to the valuation and transfer of assets but do not eliminate capital gains tax.

However, these provisions could be applied if capital gains tax was eliminated on gifts of private company shares to both private and public registered charities. The disposition would have to occur within 60 months, or no receipt could be issued by the charity. The donor would not recognize the disposition of the security at the time of the transfer; instead the tax liability would be triggered when the securities were sold by the charity within the 60-month period. To address concerns about the repurchase of the shares by non-arm's length parties at less than fair market value, the purchase price would need to be supported by a qualified independent valuation. The addition of an independent appraisal would strengthen the current provisions.

Together, these mechanisms would decrease administrative burden and risk for the charity, while providing an incentive to the donor and valuation certainty for the government. Such an incentive would primarily assist shareholders to make donations at the time a company's shares were sold, either during the donor's life or at death.

Fiscal Cost of Support for Charities.

In what follows, I provide ballpark estimates of the potential value of donations and tax revenue implications, based on the limited amount of tax data available. Actual giving levels will depend on the state of the economy and donors' responses to incentives.

Real Estate: There have been gifts of ecologically sensitive land of $494 million[6] since 1995. Using this analogous but more specialized asset class as a benchmark, it is reasonable to assume donations of taxable real estate of $100 to $200 million per annum net of existing donation levels.[7] Assuming average additional tax savings of 12.5 percent per donation,[8] and an average tax credit rate of 45 percent, the foregone federal and provincial tax would be between $60 and $115 million per annum.

Private Company Shares: It is reasonable to expect new donations of $200 to $500 million per annum if the proposed private company shares measure is adopted, net of existing donation levels. Assuming average additional tax savings of 20 percent (83 percent capital gain) and average tax credit of 45 percent, the foregone tax would be between $130 and $325 million per annum.[9]

Conclusion and Recommendations

Extending capital gains exemptions to donations of real estate and private company shares is feasible based on existing precedent in Canadian tax policy. Further, extending the capital gains tax exemption would mitigate existing inequities in tax policy, broaden the donation base for charities, and make them less vulnerable to economic swings.

5 *ITA* s. 118.1(13).

6 Environment Canada, as of July 7, 2009.

7 According to a Department of Finance study, donations of public securities took four years to reach $200 million after the reduction of capital gain in 1997.

8 Assumes marginal tax rate of 45 percent (29 percent federal + 16 percent provincial). The federal portion would be 64 percent of total tax cost. Taxable real estate has a higher adjusted cost base than private company shares because of higher initial purchase price and increases to the cost base due to capital cost allowance. The assumed average capital gain is 50 percent (hence the property would double in value since purchase).

9 Private company shares often have large capital gain, as the owner is founder and cost of shares is minimal. The average capital gain saving would therefore be higher than real estate. The $750,000 lifetime capital gains exemption for qualifying small business corporation shares, however, is a mitigating factor that would increase the cost base in many situations.

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This *e-brief* is a publication of the C.D. Howe Institute.

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