**Australian Centre for Philanthropy and Nonprofit Studies**
**MODERNISING CHARITY LAW CONFERENCE**

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# PART II: AN OVERVIEW OF CAPITAL GAINS TAX EXEMPTIONS AS A PHILANTHROPIC INCENTIVE IN CANADA

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## A. INTRODUCTION

Canada's diverse charitable sector is funded through a variety of sources and is primarily regulated by the federal government through tax administration[1] under the *Income Tax Act* (Canada)[2] (the "Act"). In addition to the usual method of making cash donations, charitable donations of particular types of capital property in Canada that are exempt, in whole or in part, from capital gains tax can provide a significant tax incentive for charitable giving. Exemptions from capital gains tax can also constitute an incentive for philanthropy in support of specific charitable purposes, such as the protection of ecosystems through the donation of ecologically-sensitive land, and the preservation of Canada's cultural and historic heritage through the donation of recognized cultural property of significance. As such, certain types of capital property in Canada are subject to specific rules that provide tax incentives through exemptions from capital gains tax under the Act when those types of capital property are donated to eligible recipients.

At present, the three types of capital property that are exempt from capital gains tax include publicly traded securities (e.g., shares and debts of publicly listed companies), cultural property (e.g., artefacts that are of significant value to Canadian heritage), and ecological property (e.g., lands that are important for the protection of the ecosystem). This paper reviews the rules pertaining to the capital gains tax exemption for

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[1] For more background on the funding and regulation of the charitable sector, see companion Part I paper by Terrance S. Carter, "An Overview of Tax Credits for Charitable Donations as a Philanthropic Incentive in Canada" (Presented to the Australian Centre for Philanthropy and Nonprofit Studies - Modernising Charity Law Conference, Queensland University of Technology, April 2009).

[2] *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.).

each of these forms of capital property, with particular attention given to the exemption of capital gains tax for donations of publicly traded securities.

### B. THE GENERAL TREATMENT OF DONATED CAPITAL PROPERTY

Technically, a separate mechanism of a "capital gains tax" does not exist in Canada, since the taxation of capital gains is achieved indirectly through the inclusion of a portion of the capital gain in the taxpayer's income, which is taxed at the applicable marginal income tax rate for the individual.[3] This is generally referred to as the "capital gains inclusion rate", which is currently 50% of the amount of the capital gain. Nevertheless, the expressions "capital gains tax" and "tax exemption" are used in this paper as general references to the various philanthropic incentives that are pursued by way of the reduction and elimination of the capital gains inclusion rate.

"Capital property" is broadly defined under the Act as any property that is depreciable or will give rise to a capital gain or loss when disposed of.[4] In general, capital gains that are accrued but not realized will not be taxed until the property is sold. However, there are exceptions to this rule because of the imposition of certain deemed dispositions under the Act, which are specific events where the taxpayer is deemed to have disposed of the property.[5] One of those events under the Act includes gifts of capital property, which are deemed to have been disposed of at the fair market value at the time the gift is made.[6] As a result, any accrued gains on such gifts are triggered for income tax purposes and must be reported.[7]

With regard to the calculation of the amount of the tax credit or deduction that is available for a gift of capital property, particular rules are applicable. Specifically, subsections 110.1(3) and 118.1(6) of the Act provide

[3] The marginal tax rate is calculated by combining the relevant federal and provincial tax rates, as both levels of government levy income taxes in Canada. For example, depending on the level of income, a resident of the Province of Ontario might pay combined taxes ranging from 21.05% to 46.41% plus provincial surtaxes. For a summary of all current federal and provincial marginal tax rates, see Canada Revenue Agency, "What are the income tax rates in Canada for 2009?", online: <http://www.cra-arc.gc.ca/tx/ndvdls/fq/txrts-eng.html>.
[4] Section 54 of the Act.
[5] David M. Sherman, *Basic Tax and GST Guide for Lawyers, 2007-2008* (Toronto: Thomson Carswell, 2007) at 215.
[6] Paragraph 69(1)(b) of the Act.
[7] David M. Sherman, *supra* note 5 at 225.

for the general rule that when a charitable gift of capital property is made,[8] of which the fair market value is higher than the adjusted cost base,[9] the donor is permitted to elect any value between the fair market value and the adjusted cost base as the applicable proceeds of the disposition.[10] For the purposes of calculating tax credits and deductions for charitable donations,[11] the fair market value of the property is deemed to be the amount elected by the donor. In essence, "these subsections permit a donor to elect out of the recognition of a capital gain",[12] although there is a corresponding reduction in the amount of the tax credit or deduction that can be claimed for the donation in question.

## C. DONATIONS OF PUBLICLY TRADED SECURITIES

### 1. Brief Background to the Charitable Donation of Publicly Traded Securities

For the purposes of discussing capital gains tax incentives in relation to donations of publicly traded securities, the term "listed securities" is the actual term that is used in the Act, which is currently defined as a share, debt obligation or right listed on a designated stock exchange,[13] a share of the capital stock of a mutual fund corporation, a unit of a mutual fund trust, an interest in a related segregated fund trust[14] or a prescribed debt obligation (these are generally referred to in this paper by their

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[8] Under the Act, a tax credit is available for various types of gifts, including charitable gifts, Crown gifts, cultural gifts and ecological gifts. See definition of "total gifts" in subsection 118.1(1) of the Act. Generally, charitable gifts are donations to registered charities in Canada and other "qualified donees." Subsection 149.1(1) of the Act provides that qualified donees are organizations that can issue official donation receipts for gifts that individuals and corporations make to them under paragraphs 110.1(1)(a) and (b) and 118.1(1). They consist of registered charities, registered Canadian amateur athletic associations, certain low-cost housing corporations for the aged, municipalities, provincial and federal governments, the United Nations and its agencies, prescribed universities outside Canada, charities outside Canada to which the federal government has made a gift in the past year, and registered national arts service organizations. In February 2004, it was proposed to amend sections 110.1 and 118.1 of the Act by including municipal or public bodies performing a function of government in Canada. This proposed amendment has been brought forth and was previously included in Bill C-33 in November 2006, which died on the Order Paper since the federal Parliament was prorogued on September 14, 2007. The proposed amendment was again re-introduced in Bill C-10 on October 29, 2007. Bill C-10 again died following the dissolution of the federal Parliament on September 7, 2008.For an explanation of cultural and ecological gifts, see section, below, entitled "Other Applications of Capital Gains Exemptions". Subsection 110.1(1) provides a tax deduction for similar gifts made by corporations, but also includes gifts of medicine.

[9] The adjusted cost base is normally the cost of the property. Special rules, such as government assistance for the purchase of property, can adjust the cost up or down. See David M. Sherman, *supra* note 5 at 216.

[10] Subsections 110.1(3) and 118.1(6) of the Act.

[11] For an explanation of the tax credit system in Canada, see companion Part I paper by Terrance S. Carter, *supra* note 1.

[12] Arthur B.C. Drache, Robert B. Hayhoe & David P. Stevens, *Charities, Taxation, Policy and Practice*, looseleaf (Toronto: Thomson Carswell, 2007), s. 18.2.1.

[13] A "designated stock exchange" is one that is designated by the Minister of Finance, and may include stock exchanges outside of Canada. For a list of current designated stock exchanges, see Department of Finance Canada, "Designated Stock Exchanges," online: <http://www.fin.gc.ca/act/fim-imf/dse-bvd-eng.asp>.

[14] A "related segregated fund trust" is, according to paragraph 138.1(1)(a) of the Act, an *inter vivos* trust "[i]n respect of life insurance policies for which all or any part of an insurer's reserves vary in amount depending on the fair market value of a specified group of properties."

common usage of "publicly traded securities").[15] The premise of encouraging charitable donations of publicly traded securities is not as historically well-rooted as that of encouraging charitable donations of cash. Indeed, it has been pointed out that Canadians generally still tend to think of cash donations when referring to charitable donations.[16] However, while the appreciation in the value of securities has been reduced over the past year due to a worldwide decline in equity markets, it has been estimated that the wealth of Canadians amassed in shares was approximately $1.4 trillion[17] at the end of 2006, and approximately half of that amount was attributable to capital gains.[18]

Notwithstanding the recent downturn in the equity markets, the donation of publicly traded securities will no doubt continue to be an important aspect of philanthropy in Canada in the future. In this regard, over the past two decades, the Canadian government has provided significant enhanced tax relief for charitable donations of publicly traded securities, with the most recent major development being the complete elimination of all capital gains taxes for donations of publicly traded securities. Given how recent this tax relief has been (i.e. only since 1997 when a partial exemption was introduced), the capital gains tax exemption for publicly traded securities has garnered significant interest from both the charitable sector and academic commentators.

The first version of the capital gains tax exemption was introduced in 1997, whereby the normal capital gains inclusion rate of ¾ was reduced by half for donations of publicly traded securities (i.e. ⅜ or 37.5%),[19] with a caveat that the exemption was not applicable to donations to private foundations.[20] In February 2000, the inclusion rate was reduced to ⅔, with a corresponding reduction to ⅓ for donations of publicly traded securities.[21] In October 2000, in light of strong economic growth, the federal

[15] Paragraph 38(a.1) of the Act. The 2000 and 2008 federal government budgets, in effect, broadened this definition of listed securities by extending the capital gains tax exemption to listed securities that are donated within 30 days of being acquired (a) under an employee stock option plan, or (b) through an exchange from unlisted securities.
[16] Craig Alexander, "Donating Securities Makes Good Financial Sense" *TD Economics Special Report* (1 May 2007) at 1, online: <http://www.td.com/economics/special/ca0507_securities.pdf>.
[17] All monetary figures herein are in Canadian dollars.
[18] Craig Alexander, *supra* note 16 at 2.
[19] Department of Finance Canada, *Budget 1997: Building the Future for Canadians* (Ottawa: Department of Finance Canada, 1997).
[20] There are three types of registered charities in Canada – charitable organizations, public foundations, and private foundations. Foundations (both public and private) are generally distinguished by their focus on funding charitable organizations that perform charitable activities rather then performing the activities themselves. In general terms, public foundations are currently distinguished from private foundations by the requirement that the former must have a board of directors where more than 50% of the board must be at arm's length to each other, and cannot be controlled directly or indirectly by a person (or persons) who has donated more than half of its capital. For further explanation of the types of registered charities in Canada, see Theresa L.M. Man & Terrance S. Carter, "A Comparison of the Three Categories of Registered Charities" (2006) 20 The Philanthropist 69.
[21] Department of Finance Canada, *The Budget Plan 2000: Better Finances, Better Lives* (Ottawa: Department of Finance Canada, 2000).

government further reduced the inclusion rate to the current rate of ½, with a corresponding reduction to ¼ for donations of publicly traded securities.[22] The exemption was initially set for a five-year trial period, but in 2001, the Canadian government announced that the 1997 measure would be made permanent.[23] In 2006, the capital gains tax was completely eliminated for charitable donations of publicly traded securities to charitable organizations and public foundations.[24] In March 2007, the exemption was extended to donations of publicly traded securities to private foundations.[25]

From this brief overview, there were two milestones in the development of the capital gains tax exemption that we can statistically assess its effect with regard to being a philanthropic incentive – firstly, its introduction in 1997, in which the inclusion rate was halved, and secondly, the elimination of the capital gains tax altogether in 2006. The balance of this section of the paper reviews the rationale for the capital gains tax exemption for donations of publicly traded securities; how it functions at a practical level; how it has affected charitable giving thus far; and how it might impact the future of philanthropy in Canada.

## 2. The Rationale for the Exemption

As indicated above, the 1997 federal budget introduced partial tax exemption for charitable donations of publicly traded securities.[26] It was stated at that time that the objective was, firstly, to increase charitable donations, and secondly, to distribute the increased donations fairly among charities.[27] One of the major impetuses for the introduction of a capital gains exemption was the representations made to the Canadian government by various charitable groups, noting that donations of appreciated capital property, generally, were given more generous tax treatment in the United States than in Canada through an exemption from capital gains tax.[28] In this regard, the 1997 budget also included a basic comparative analysis of the American and Canadian tax treatment of charitable donations, explaining that Canada had a far more generous scheme for cash donations, but noting "a marked distinction in giving patterns between the two countries for larger donations of appreciated capital property."[29] As

[22] Department of Finance Canada, *Economic Statement and Budget Update* (Ottawa: Department of Finance Canada, 2000).
[23] Department of Finance Canada, *The Budget Plan 2001* (Ottawa: Department of Finance Canada, 2001).
[24] Department of Finance Canada, *The Budget Plan 2006: Focusing on Priorities* (Ottawa, Department of Finance Canada, 2006).
[25] Department of Finance Canada, *The Budget Plan 2007: Aspire to a Stronger, Safer, Better Canada* (Ottawa: Department of Finance Canada, 2007).
[26] Department of Finance Canada, *supra* note 19.
[27] Department of Finance Canada, *Tax Expenditures and Evaluations, 2002* (Ottawa: Department of Finance Canada, 2002) at 61.
[28] Department of Finance Canada, *supra* note 19 at 112-113.
[29] *Ibid.* at 113.

such, a significant aspect of the rationale for introducing the particular exemption for publicly traded securities was that it would "give Canadian charities access to the sort of large donations of securities that U.S. charities raise by providing a level of tax assistance for these donations that is comparable to that in the U.S."[30]

One of the reasons for comparing the Canadian and U.S. tax treatment of charitable donations was because Canadian charities were considered to be at a competitive disadvantage to their American counterparts, particularly with respect to the international competitiveness of Canadian universities, medical and other research institutions.[31] This reasoning or justification was not accepted by some critics who questioned the relevance of an "American model of philanthropy" in Canada and suggested the possibility that Canadians may prefer a different balance between the roles of government and charities in providing services.[32]

Other critics stated that the incentives created by the tax exemption for publicly traded securities diminished the reality that the 1997 budget was actually putting severe restrictions on private securities, to the extent that "charities are now effectively denied the ability to receive gifts of debt obligations and shares in private Canadian companies no matter how secure and conservatively valued they may be."[33] The government's general concern related to practices that allowed taxpayers to make charitable donations, receive tax credits for the donations, but still retain effective use of the donated property.[34] The specific rationale for the restriction against private securities was to address a form of tax avoidance, where, in a typical scenario, the donor would make a donation of securities from the donor's private company to a charity, and then borrow from the same charity to finance the donor's company.[35] In more simple terms, the 1997 budget proposed a response to these concerns by imposing a "punitive tax" on a charity that received a private company's debt or share.[36] These provisions were met with a chorus of complaints from the charitable sector, including criticism that the concerns of tax

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[30] *Ibid.* at 114.
[31] William I. Innes, "The Case for Tax Incentives on Gifts of Publicly Traded Securities" (2003), 51 Can. Tax J. 905 at 910.
[32] Lisa Philipps, "Thinking Critically About the Taxation of Capital Gains on Donated Public Securities (or Looking Paragraph 38(a.1) in the Mouth)" (2003) 51 Can. Tax J. 913 at 917.
[33] Blake Bromley, "Dolphins, Tuna and Mudsharks: Reflections on the "Bre-X Budget" for Charities" (1997) 14 The Philanthropist 27 at 27.
[34] M. Elena Hoffstein, "Private Foundations and Community Foundations" in *Conference Report 2007: Report of Proceedings of the Fifty-Ninth Tax Conference* (Toronto: Canadian Tax Foundation, 2007), 32:1 at 9.
[35] Arthur B.C. Drache, Robert B. Hayhoe & David P. Stevens, *supra* note 12, s. 18.5.2.
[36] Arthur B.C. Drache, "Federal Tax Changes and Personal Tax Planning" (Paper presented at the Canadian Bar Association - Ontario Continuing Legal Education Seminar – Charity and Not-For-Profit Law: The Emerging Specialty, Toronto, May 1997) at 8.

administrators were based merely on unproven allegations of abuse, without specific cases being revealed.[37] The government made some concessions in response to this criticism, and the Act now includes anti-avoidance provisions[38] that effectively postpone donations of these securities until they are converted into cash (or cash equivalent) by the charity, or until the donor no longer deals with the charity on a non-arm's length basis.[39]

3. <u>How the Capital Gains Tax Exemption Works for Publicly Traded Securities</u>

The premise for the complete exemption from capital gains tax on publicly traded securities[40] is that no appreciation in their value is included in the donor's taxable income if the property is donated to a qualified donee.[41] This philanthropic incentive not only means that the donation of publicly traded securities is more attractive than before, but it can also be potentially more beneficial than donations of cash. This can be illustrated by the following examples.

Firstly, consider an individual, Anna, who would like to donate $1,000 to a registered charity. She has the ability to do so with $1,000 in cash, or with publicly traded shares that were bought for $400 but which have appreciated to the current fair market value of $1,000. If Anna was taxed at the highest combined federal-provincial marginal tax rate of 46.41% in Ontario, a donation of $1,000 in cash would generally provide a non-refundable tax credit of $464.10.[42] However, if Anna directly donated the shares, she would still receive a $464.10 tax credit, but no portion of the $600 in capital gains would be included in her taxable income. There is therefore no direct tax disadvantage to Anna in donating the shares, giving her the flexibility to choose two different methods of making the same amount of donation. From the perspective of increasing philanthropy, Anna may even be willing to donate cash in addition to the shares, because the implication of the appreciated value of the shares is that the real cost to Anna has been significantly less than $1,000 (i.e. the cost of the shares at $400).

Secondly, consider an alternative scenario in which Anna no longer has the option of donating $1,000 in cash. In this case, she can still make a cash donation by selling the shares, or she can directly donate the

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[37] Blake Bromley, *supra* note 33 at 31.
[38] Subsections 118.1(13) to (20) of the Act.
[39] Arthur B.C. Drache, Robert B. Hayhoe & David P. Stevens, *supra* note 12, s. 18.5.2(1).
[40] Paragraph 38(a.1) of the Act.
[41] See *supra* note 8 for details of what is included under the definition of qualified donee.
[42] Because a two-tiered tax credit is used in Canada, in which the lower tier is credited at a lower rate than the upper tier, the amount of tax credit calculated in these examples is simplified by assuming that the individual has already made charitable donations of at least $200 for the year. See companion Part I paper by Terrance S. Carter, *supra* note 1.

shares. This presents the opportunity to compare the tax effects on a direct donation of publicly traded securities, as opposed to the donation of cash from selling those securities, which is succinctly summarized by the following example:

> If the shares are sold and then the cash donated, the individual will have a capital gain of $600, which will be taxed as if 50% were income... there would be capital gains taxes of $139.23, leaving the investor with a donation of $860.77, for which they would receive a tax credit of $399.48.
>
> Now consider the direct donation of $1,000 worth of shares. The tax credit at the 46.41% tax rate is a larger $464.10 and the $139.23 of capital gains taxes is completely avoided. So, the total benefit to the charity is $1,000 and the total benefit to the investor is more than $600. Both the charity and the donor are better off when the securities are directly given to charity than when the shares are first sold and the after-tax proceeds donated.
>
> Moreover, in this particular case, since the shares were bought for $400 and the tax credit was $464, the investor made a profit of more than $60 relative to the initial purchase price in addition to the $1000 donated to the charity. It should be stressed that a profit will not always occur, as the accumulated capital gains must be 100% larger than the initial cash purchase.[43]

4. <u>Application of the Capital Gains Tax Exemption to Flow-Through Shares</u>

Although it was not a stated intention at the time of the initial introduction of the capital gains tax exemption for publicly traded securities, another application of the tax exemption applies in conjunction with donations of "flow-through shares". Flow-through shares were tax incentives introduced by the Canadian government to encourage exploration of Canada's rich natural resources in oil, gas and mining. In essence, flow-through shares allow corporations to "flow-through" income tax deductions associated with resource exploration to their shareholders.

In the context of charitable donations, the potential benefit of flow-through shares can be illustrated by the following example:

> Assume that an investor, instead of purchasing non-flow-through shares, acquires $1,000 of flow-through shares of a publicly-listed corporation. Over the course of the exploration period, the investor will be entitled to $1,000 in flow-through deductions related to the exploration expenses resulting in tax savings of about $460 (assuming a 46% marginal tax rate) and reducing the adjusted cost basis of the shares to nil. At this point, the $1,000 flow-through shares will have effectively cost only $540. When exploration is completed and the investor has claimed the maximum possible amount of exploration deductions, the shares may be [donated]. Assuming that the value of the shares remains $1,000, the investor will be entitled to a federal

[43] Craig Alexander, *supra* note 16 at 2.

> donation tax credit in respect of the $1,000 donation of $262, which results in another tax savings of about $460, and will not be taxed on the capital gain. As a result, the investment and, thereafter, donation to charity of $1,000 will only cost the investor/donor $80.[44]

5. The Impact of the Capital Gains Tax Exemption for Publicly Traded Securities

While there is statistical evidence specifically relating to the donation of securities after 1997, unfortunately there is no statistical evidence before then, presumably because there was no tax policy reason to single out this type of capital gift. Based on a private survey of 606 charities conducted in 2000, it was found that the average value of donations of publicly traded securities in the period of 1997 to 1999 nearly quadrupled, from $64,893 to $251,626.[45] As the 1997 provision approached the end of the five-year trial period, the government also sought to examine the effects the exemption may have had on trends in charitable donations of publicly traded securities at that time. In this regard, the Department of Finance released statistics and a report in 2002 pertaining to the charitable donation of publicly traded securities.[46] The report indicated that in the period of 1997 to 2000, the total value of such donations nearly tripled from $69.1 million to $200.3 million, and the number of donors of publicly traded securities increased from 500 to nearly 2,400.[47]

The statistics reported by the government appeared to indicate a substantial growth in the donation of publicly traded securities. Other findings of the report were that the recipient charities of the donations of publicly traded securities varied widely in terms of size, sector, and type, but the main beneficiaries were larger charities, educational institutions and public foundations. While these statistics and findings appear positive, the Department of Finance stated clearly that the nexus between the tax exemption and these increases could not be firmly established. Data prior to 1997 was unavailable, and as such, no comparisons could be made before and after the introduction of the tax exemption. It was also cautioned that any effects of the tax incentive could not be isolated from other factors, such as other government policies or the effects of the financial market itself.

Therefore, the statistical data from 1997 to 2000 cannot by itself prove how much of the growth was actually attributable to the capital gains tax exemption, but it does indicate that donations of publicly traded securities increased dramatically. Moreover, in terms of the cost of the tax incentive, it appears

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[44] Theresa L.M. Man, Karen J. Cooper & Terrance S. Carter, "Donation Tax Shelters Involving Flow-Through Shares" *Charity Law Bulletin* 116 (12 June 2007) at 4, online: <http://www.carters.ca/pub/bulletin/charity/2007/chylb116.pdf>.
[45] Deloitte and Touche, *Survey of Gifts of Publicly-Listed Securities: Final Report* (Toronto: Deloitte and Touche, 2000).
[46] Department of Finance Canada, *supra* note 27 at 61.
[47] *Ibid.* at 64.

that the government's foregone tax revenues were relatively minimal. Assuming that all the donations of publicly traded securities were actually effected by the tax exemption, the Department of Finance reported that the government's forgone tax revenues increased from $26 million to $73 million between 1997 and 2000.[48]

In 2001, the government decided to permanently adopt the partial capital gains tax exemption, presumably based upon the data that was released later by the Department of Finance,[49] and these developments renewed the academic discussion on the rationale and justification for providing tax relief for donations of publicly traded securities. In concluding that the tax exemption was successful and desirable, one commentator placed emphasis on the fact that the donations of publicly traded securities increased disproportionately compared to donations of cash, the former increasing by 190% and the latter only by 18% from 1997 to 2000, which, combined with anecdotal evidence, would appear to indicate that the exemption did facilitate the increase.[50] The same commentator also suggested other policy reasons in support of the exemption, including the argument that the government's estimated tax expenditure (i.e. foregone revenues) was likely to be much less than projected; the importance of encouraging donations to educational/medical/research institutions, which received 56.1% of publicly traded securities donations over the reported period; and the importance of donating to public foundations, which could provide long-term endowments to the actual charitable organizations (almost 60% of the securities donations went to public foundations).[51]

Another commentator stated that there was a heavy onus on the government to justify that charitable tax incentives are indeed "producing demonstrably positive effects on the quantity and quality of services available to those who need them."[52] It was argued that the Department of Finance's 2002 report did not provide the clear indicators to satisfy the criteria that the government itself set out as being necessary to justify the permanent adoption of the exemption.[53] Particularly, the commentator emphasized the express admission that the statistics could not prove whether or not the exemption

[48] *Ibid.* at 68.
[49] Department of Finance Canada, *supra* note 27.
[50] William I. Innes, *supra* note 31 at 909-910.
[51] *Ibid.* at 910-911.
[52] Lisa Philipps, *supra* note 32 at 915.
[53] *Ibid.* at 919.

actually facilitated the increase in donations and that there was unclear evidence of equal distribution of the donations across the charitable sector.[54]

A further commentator placed particular emphasis on three concerns regarding the tax assistance afforded by the exemption.[55] Firstly, if the incentive is indeed to encourage specific types of giving, such as donations to educational institutions, then there may be a conflict with the "underlying rationale of tax incentives for charitable giving to promote pluralism in the allocation of public funds."[56] Secondly, the distributional impact of the exemption is arbitrary and inequitable, in that it depends on the appreciation of the security and the donor's marginal tax rate (at least prior to the complete exemption from capital gains tax in 2006). Thirdly and most importantly, it creates a donation system more favourable to high income groups (the percentage of total charitable donations from donors with incomes exceeding $250,000 increased from 11.4% in 1996 to 21.0% in 2000), which creates the situation "whereby the mix of goods and services provided by the charitable sector is shaped more by an affluent minority than by the community as a whole."[57]

Notwithstanding the differing positions of academics and tax analysts, proposals for the complete elimination of capital gains tax for donations of publicly traded securities continued to surface, and many charities continued to state that the elimination, or at least a further reduction in the inclusion rate, would be beneficial. In this regard, a large number of charities acted as witnesses before the Standing Senate Committee on Banking, Trade and Commerce to advocate these positions in 2004.[58] The 2006 federal budget responded to these proposals and requests from the charitable sector by totally eliminating the capital gains tax for donations of publicly traded securities.[59]

While the stated objective of the additional tax assistance was to continue encouraging charitable donations and to assist in providing charities with a powerful set of fundraising tools,[60] it is not known whether or not this further tax incentive has in fact generated a proportionally higher level of charitable

[54] *Ibid.* at 919-923.
[55] David G. Duff, "Special Tax Assistance for Charitable Donations of Publicly Traded Securities: A Tax Expenditure Analysis" (2003), 51 Can. Tax J. 925 at 932.
[56] *Ibid.*
[57] *Ibid*. at 933.
[58] See, for example, Standing Senate Committee on Banking, Trade and Commerce, *The Public Good and Private Funds: The Federal Tax Treatment of Charitable Giving by Individuals and Corporations* (Ottawa: Standing Senate Committee on Banking, Trade and Commerce, 2004).
[59] Department of Finance Canada, *supra* note 24.
[60] *Ibid.* at 121.

giving. Certainly, a number of fundraising organizations, such as the Association of Fundraising Professionals and the Canadian Association of Gift Planners, applauded the developments, and a number of well-publicized transactions were documented soon after the provision came into effect.[61]

In terms of statistical data, a limited amount of quantitative evidence is currently available based on a survey conducted by Imagine Canada.[62] These findings are promising, indicating that the donations of publicly traded securities increased between 2005 and 2006 – the number of charities receiving donations of securities increased from 43% to 49%; the number of donations more than doubled from 1,182 to 2,502; and the total value of donations doubled from $122 million to just under $245 million.[63] However, most donations went to the largest charities, as 90% of the value of the donations was given to charities with annual revenues of $10 million and more. Because of the limited number of survey respondents and the over- representation of large organizations, these figures are not sufficient to support broad conclusions regarding the charitable sector as a whole. However, the general findings do appear to bear some semblance to the earlier government-reported statistics that suggested that a reduction in the capital gains tax for publicly traded securities did increase philanthropy.[64]

## D. OTHER APPLICATIONS OF CAPITAL GAINS EXEMPTIONS

### 1. Ecological Gifts

With the objective of protecting Canada's environmental heritage and biodiversity, the Canadian government established the Ecological Gifts Program by providing capital gains tax incentives for donations of ecological gifts.[65] Specifically, a capital gains exemption strategy was first introduced by the government in 2000, in tandem with the exemption of publicly traded securities from capital gains tax, as described above. In February 2000, the inclusion rate was reduced to ⅔, with a corresponding reduction to ⅓ for donations of ecological gifts.[66] In October 2000, the inclusion rate was further reduced to the current rate of ½, with a corresponding reduction to ¼ for donations of ecological

[61] Karen J. Cooper, "Budget 2006: Elimination of Capital Gains Tax on Certain Gifts" *Charity Law Bulletin* 94 (30 May 2006) at 1, online: <http://www.carters.ca/pub/bulletin/charity/2006/chylb94.pdf>.
[62] David M. Lasby & Michael H. Hall, *Charitable Gifts of Securities: Implications for Canadian Organizations* (Toronto: Imagine Canada, 2007).
[63] *Ibid*. at 6-7.
[64] Department of Finance, *supra* note 27.
[65] Paragraph 38(a.2) of the Act. Pursuant to s. 110.1(1) and the definition of "total gifts" in s. 118.1(1) of the Act, for donations of ecological gifts, donors may also claim a tax credit for donations of up to 100% of the donor's net income, as opposed to the ceiling of 75% for charitable donations in general.
[66] Department of Finance Canada, *supra* note 21.

gifts.[67] The capital gains tax on gifts of ecological property was eliminated altogether in the 2006 federal budget.[68] Given that the government only anticipated that the tax incentive would cost $5 million per year in the two years after the 2006 budget, the exemption for ecological property was not a large amount of tax expenditure in comparison with the exemption for publicly traded securities, which was estimated to cost $50 million per year.[69]

An ecological gift is generally defined as "a donation of land or a partial interest in land, such as a conservation easement, covenant, or servitude. In order for such gift to meet the requirements of the Ecological Gifts Program, the Environment Minister must certify the land as ecologically sensitive, approve the recipient to receive the gift, and certify the fair market value of the donation."[70] As such, there is a significant degree of government involvement in the implementation of the program. Government regulation specifically involves three determinations, each necessitating a number of procedural steps.

a) Eligibility of the Recipient

Firstly, the recipient of the ecological gift must be an eligible recipient, such as a Canadian territorial, provincial or federal department or agency; municipality; or a registered charity which has the main purpose of environmental protection and conservation. An eligible registered charity must be expressly approved by the Minister of the Environment, and in this regard, there are currently over 190 eligible registered charities in Canada.[71]

b) Ecological Sensitivity of the Land

Secondly, the land (which includes a servitude, covenant or easement) must then be certified to be ecologically sensitive, such that its conservation and protections is important. The government has developed a definition of the term "ecologically sensitive land" using specific national and provincial criteria, and the Minister of the Environment may designate other government officials (and in some

[67] Department of Finance Canada, *supra* note 22.
[68] Department of Finance Canada, *supra* note 24.
[69] *Ibid.* at 202.
[70] Environment Canada, *The Ecological Gifts Program* (Gatineau: Environment Canada, 2007), online: <http://www.cws-scf.ec.gc.ca/egp-pde/E6E3313F-59A4-43A9-9D84-7F5A1EBCA58F/bro_e.pdf>.
[71] Environment Canada, "The Ecological Gifts Program – Who can receive an ecogift?", online: <http://www.cws-scf.ec.gc.ca/egp-pde/default.asp?lang=En&n=9D3A4276-1>.

limited situations, non-governmental conservation organizations) to be responsible for certifying the land to be ecologically sensitive.

c) Fair Market Value of the Land

Thirdly, after the land is certified to be ecologically sensitive, its fair market value must be certified by the government. The donor must submit an independent appraisal of the land to a separate Appraisal Review Panel for review. The Panel will then make a recommendation of the fair market value to the Minister of the Environment for determination and certification. A donor who is not satisfied with this determination has recourse to apply for redetermination and further appeal.[72]

The capital gains tax exemption for ecological property is an important effort by the Canadian government to promote a specific type of philanthropic cause, and reflects the ability of lawmakers to direct charitable donations through tax incentives for specific types of donations. In terms of measuring the impact of the tax incentives, there is some indication that donations of ecological property increased after the introduction of the tax exemption in 2000. According to a 2003 government report, the number of ecological gifts increased from 34 gifts pre-2000, up to 52 gifts following 2000.[73] By March 2008, a total of 652 ecological gifts valued at over $379 million had been made in Canada.[74]

2. Gifts of Cultural Property

The capital gains tax exemption for donations of cultural property was first introduced in 1977.[75] The Act was amended at that time to create the capital gains tax exemption by excluding the donation of cultural property altogether from the meaning of "a taxpayer's capital gain for a taxation year from the disposition of any property".[76] Generally, the incentive functions in a similar way to that of donations of ecological gifts, as described above, in that it promotes a particular type of philanthropic cause and is regulated and administered closely by the relevant governmental authority to ensure that the program objectives are being met. The procedure for making a gift of cultural property involves three regulatory

[72] Karen J. Cooper, "Gifts of Environmentally Sensitive Land: What You Need to Know and How to Use Them" (Paper presented to the CBA/OBA 2008 National Charity Law Symposium: New Thoughts On Gifting, Toronto, May 2008) at 3-4.
[73] Environment Canada, *The Ecological Gifts Program: Progress Report, 1995-2003* (Gatineau: Environment Canada, 2003), online: <http://www.cws-scf.ec.gc.ca/egp-pde/default.asp?lang=en&n=B22715BF>.
[74] Karen J. Cooper, *supra* note 72 at 1.
[75] S.C. 1974-75-76, c. 50, s. 48.
[76] Subparagraph 39(1)(a)(i.1) of the Act. Pursuant to s. 110.1(1) and the definition of "total gifts" in s. 118.1(1) of the Act, for donations of cultural property, donors may also claim a tax credit for donations of up to 100% of the donor's net income, as opposed to the ceiling of 75% for charitable donations in general.

mechanisms that are generally the same as those applicable to ecological gifts. In this regard, the relevant governmental authority is the Canadian Cultural Property Export Review Board (the "Board"), which ensures that the property meets certain criteria, has an appropriate fair market value, and is being donated to an approved recipient.

a) Designation of the Recipient

The recipient of the gift of cultural property must be a designated "institution or public authority",[77] which typically include museums and art galleries across Canada. Procedurally, the roles of the donor and the recipient have been explained as follows:

> For cultural property to be considered for certification, a donor or vendor of cultural property must first reach a tentative agreement concerning the donation or sale with an institution or public authority designated by the Minister of Canadian Heritage. Designated institutions or public authorities typically make applications for certification to the Board on behalf of donors or vendors.[78]

b) Certification of the Property

The capital property must be an object that has been determined by the Board to have met certain statutory and regulatory criteria.[79] This criteria includes that the donated property must be "of outstanding significance by reason of its close association with Canadian history or national life, its aesthetic qualities, or its value to the study of the arts of sciences" or of "such a degree of national importance that its loss would significantly diminish the national heritage."[80]

c) Determination of Fair Market Value

Similar to ecological gifts, the fair market value of the cultural property is also subject to regulatory oversight, but with regard to gifts of cultural property, the property's value is actually established by the Board when it is being certified as cultural property.[81] Procedures for redetermination and appeal are also provided.[82] The issue of valuation is complex and often contentious, given the lack of well-defined criteria, such that "[i]n valuing a work of art there are many variables and subjective

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[77] *Ibid.*
[78] Department of Canadian Heritage, *Cultural Property Export and Import Act: Annual Report, 2006-2007* (Gatineau: Canadian Heritage, 2008) at 5.
[79] Subparagraph 39(1)(a)(i.1) of the Act.
[80] *Cultural Property Export and Import Act*, R.S.C. 1985, c. C-51, ss. 29(3)(b) and (c).
[81] Subsection 118.1(10) of the Act.
[82] *Cultural Property Export and Import Act*, *supra* note 80, ss. 32 and 33.1.

elements that can result in differences in estimates of value that may vary within a range of indeterminate magnitude."[83]

With respect to the effects of this capital gains tax exemption, there does not appear to be any relevant statistical data during the period in which the exemption was introduced from which conclusions can be drawn. Statistics from the period of 1992 to 2004 indicate that the number of annual applications to the Board for determination or redetermination ranged from 926 to 1,489, but revealed no identifiable trends.[84]

## E. CONCLUSION

Assuming that appreciating market values and income tax consequences are the primary considerations for a donor and recipient charity, the capital gains tax exemption for publicly traded securities means that the donation of publicly traded securities, assuming they have appreciated in value, will generally provide more benefit to a donor than a donation of cash at the same fair market value. Despite the lack of conclusive data with respect to the effectiveness of this incentive, there are general implications that can be identified from the perspective of encouraging philanthropy.

Firstly, the tax exemption provides a vast additional source of economic wealth from which donors can potentially give. To the extent that this actually serves the purpose of increasing total charitable donations, rather than merely replacing donations of cash, the exemption has the potential to significantly increase philanthropy. Secondly, the combined effect of the capital gains tax exemption and tax credit significantly reduces the real cost of giving to donors by allowing them to retain all the profit from accumulated capital gains, and in some situations, generate additional profit through a tax credit that may be larger than the original cost of the securities. To the extent that donors recognize these benefits and are willing to donate a higher amount than they otherwise would have donated through cash only, total charitable giving could also increase.

Statistics relating to the effectiveness of the capital gains tax exemption for ecological gifts are promising, although no conclusions can be drawn for cultural property. Nevertheless, while donations of ecological or

[83] *Maréchal v. Canada* (2004), 2004 TCC 464 at para. 15. For discussion on the complexities of cultural property valuation, see Steven L. Nemetz, "Gifting Cultural Property in Canada: Testing a Tax Expenditure" (2006) 85 Can. Bar Rev. 457 at 476.

[84] Department of Canadian Heritage, *Cultural Property Export and Import Act: Cumulative Report 1992-1993 to 2003-2004* (Gatineau: Canadian Heritage, 2005) at 30.

cultural property are quantifiable, their monetary value cannot be as easily measured or compared with publicly traded securities. Conceptually, ecological gifts and cultural property are not necessarily meant to provide greater economic wealth to support charitable purposes, but instead are primarily means to encourage cultural and ecological preservation. As such, the author is not aware of any assessment that has been made for the comparative success of the capital gains tax exemptions for these types of capital property.

Recently, there have been efforts to continue expanding the tax incentives for charitable giving in Canada through the suggested introduction of new capital gains tax exemptions, including proposals to expand the capital gains tax exemption to donations of real estate and shares of private corporations.[85] In this regard, numerous charities and professional fundraising organizations have lobbied the government to expand the capital gains incentives to real estate, stating that equal incentives to more types of assets will give donors alternative options to donate when equity markets are weak, and that real estate is the most widely-held asset in Canada but is rarely donated to charities.[86] It has been pointed out that both real estate and private company shares generally have significant value, and that many properties may also have an extremely low adjusted cost base.[87] Furthermore, although it is recognized that the valuation of shares in private corporations is not readily available when compared to their public counterparts, rules and standards for valuation and appraisal have been established in the United States.[88] These proposals are not necessarily new in Canada, but they have not yet attracted the serious interest of the Canadian government.

In Canada, capital gains tax exemptions for charitable donations of capital property have expanded significantly over the last two decades, most notably through the extension of the exemption to donations of publicly traded securities and the subsequent reduction of the inclusion rate to zero. In light of the stated objective for the tax exemption to be comparable to the American model, it is possible that Canadian capital gains tax exemptions may continue to expand in the future.

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[85] See, for example, Sandra Hamilton, "Barriers to Canadian Charitable Giving: Emerging Income Tax Issues for Individual Donors" (Presentation to the C.D. Howe Institute Policy Conference – Strengthening Canada's Charities: Examining Challenges to Canada's Third Sector, Toronto, November 2008).
[86] Standing Senate Committee on Banking, Trade and Finance, *supra* note 58 at 10.
[87] Sandra Hamilton, *supra* note 85.
[88] *Ibid*.