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BUDGET 2006: ELIMINATION OF CAPITAL GAINS TAX ON CERTAIN GIFTS

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A. INTRODUCTION

In the 2006 Federal Budget released on May 2, 2006,[1] the Conservative government upheld its commitment to remove the capital gains tax on listed securities donated to charities[2] and extended this measure to gifts of ecologically sensitive land, effective immediately. These measures will significantly impact the charitable sector. While these measures do not apply at present to private foundations, the government indicated in the Budget that it will consult with the sector to develop some self-dealing rules to safeguard against potential conflicts of interest. Both the Canadian Association of Gift Planners and the Association of Fundraising Professionals have applauded these changes indicating that they will encourage increased charitable giving in Canada. Most recently, the Toronto General Hospital received a donation of $37 million and the UJA Federation of Greater Toronto received $50 million, both donations a direct result of the new measures. [3] The following provides a brief discussion of the current regime applicable to such donations in order to better understand the new measures and their impact on donors and charities.

[1] See http://www.fin.gc.ca/budget06/bp/bpc3ce.htm#donations for the relevant section of the Budget 2006 documents.
[2] Available at www.conservative.ca/en/1091/38163. See *Charity Law Bulletin* No. 89 for a discussion of the commitment.
[3] See news article at http://www.cbc.ca/story/science/national/2006/05/30/munk.html.

B. EXISTING PROVISIONS

Generally, a taxpayer who disposes of property by way of gift is deemed to have received proceeds of disposition equal to the fair market value (FMV) of the property at that time under paragraph 69(1)(b) of the *Income Tax Act* (ITA). If the FMV of the property exceeds its adjusted cost base (ACB),[4] the taxpayer will realize a capital gain as a result of such a disposition. For most gifts of property, 50% of the capital gain is included in income for the year and is subject to tax.[5] For example, if an individual gifts an antique desk to a registered charity that she paid $100 for (the ACB) and which now has a FMV of $1,000, she will realize a capital gain of $900 and a taxable capital gain (the amount she will have to include in her taxable income) of $450. Assuming that she is taxed at the top marginal tax rate of 46%,[6] she would pay $207 in tax on the donation. Of course, she will also be able to claim a donation tax credit pursuant to subsection 118.1(3) for the entire amount of the gift ($1,000 - assuming that this is her only donation, the value of the tax credit would be $262).[7] The calculation would be the same if she donated land, which does not qualify as an ecological gift, with an ACB of $100 and a FMV of $1000.[8] The donation tax credit of $262 will offset the impact of the taxable capital gain, but the donation tax credit would have had a greater impact on her tax situation if she had donated cash.

In the 1997 Budget, Parliament enacted paragraph 38(a.1) of the ITA, which reduces the inclusion rate on capital gains arising from a gift of various types of property,[9] including publicly traded shares, where the gift is to a qualified donee[10] other than a private foundation. Paragraph 38(a.2), providing for the same treatment with respect to ecological gifts, was introduced by the 2000 Budget, effective February 27, 2000. The inclusion rate for both types of property was 25% of the capital gain, instead of 50%.

[4] The ACB of property is usually the cost of a property plus any expenses to acquire it, such as commissions and legal fees. The cost of a capital property is its actual or deemed cost, depending on the type of property and how it was acquired. For more information on ACB, see *Interpretation Bulletin IT-456, Capital Property - Some Adjustments to Cost Base*, and its Special Release.
[5] Paragraph 38(a).
[6] The 2006 Budget has also reduced the lowest tax rate, but we have not made any adjustments to the top marginal tax rate.
[7] We have used the new effective bottom rate for 2006 of 15.25%.
[8] See *Charity Law Bulletin* No. 81 for a detailed discussion of the ITA provisions related to donations of ecologically sensitive land.
[9] Paragraph 38(a.1) applies to a gift of "a share, debt obligation or right listed on a prescribed stock exchange, 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 (within the meaning assigned by paragraph 138.1(1)(a)) or a prescribed debt obligation."
[10] Subsection 149.1(1) of the ITA defines "qualified donees" to include donees described in sections 110.1 and 118.1 of the ITA: a registered charity; a registered Canadian amateur athletic association; a housing corporation resident in Canada constituted exclusively to provide low-cost housing for the aged; a Canadian municipality; the United Nations and its agencies; a prescribed university that is outside Canada; a charitable organization outside Canada to which Her Majesty in right of Canada has made a gift; and Her Majesty in right of Canada or a province. It has also been proposed to expand the list of "qualified donees" as defined in subsection 149.1(1) to include municipal or public bodies performing a function of government in Canada.

In contrast to the example above, a donation under the existing provisions of publicly traded shares or an ecological gift with an ACB of $100 and a FMV of $1,000 to a registered charity, other than a private foundation, will result in a taxable capital gain of only $225 (25% of $900). The tax on the capital gain will be $103, again to be offset by the donation tax credit of $262. The donation tax credit would have had a greater impact on the donor's tax situation had she donated cash, but she is better off than if she donated the antique desk or land which does not qualify as an ecological gift.

In a recent Special Report authored by Don Drummond, Senior Vice-President and Chief Economist,[11] TD Economics notes that from 1997 to 2000 (immediately after the reduction of the capital gains inclusion rate on gifts of listed securities to 25%) gifts of publicly traded securities to charities increased from $69.1 million to $200.3 million, and the share of total donations represented by stocks increased from 1.6% to 3.9% of all donations. However, many in the charitable sector had noted that the fact that the transactions result in some tax payable, albeit completely offset by the donation tax credit, has had a chilling effect on many donations of publicly listed securities or ecologically sensitive land.

C. BUDGET 2006

In the 2006 Budget, the federal government proposes to completely eliminate the capital gains tax on certain gifts of publicly listed securities and ecologically sensitive land, measures which it maintains will provide the charitable sector with a "powerful set of tools" for raising funds and encouraging charitable giving. Donors would not be taxed on any of the capital gain accrued on the donated property and would receive the full benefit of the donation tax credit on the donation. In contrast to the example above, a donation of publicly traded shares or an ecological gift with an ACB of $100 and a FMV of $1,000 will result in no taxable capital gain. Therefore, the entire amount of the donation tax credit of $262 will be available to be used against other sources of income. In effect, the government proposal would mean that the tax benefit arising from a gift of publicly traded securities or ecologically sensitive land would be the same as if it were a gift of cash.

The Budget documents suggest that by completely eliminating the capital gains tax on such donations, the donors' cost of making the donation will also decrease from 47% (the cost if the current rules

[11] Available at http://www.td.com/economics/special/dd0206_charity.pdf.

continued to exist) to 40% or, in other words, the tax assistance provided by the government to encourage such donations will increase from 53% to 60%.[12] This may result in a net benefit to the donor for choosing to donate publicly traded shares, or ecologically sensitive land, instead of cash, as more explicitly explained below.

Don Drummond, in the TD Special Report, compares a cash gift of $100 to a gift of publicly traded shares with an ACB of $40 and a FMV of $100 (see Table 1). A charitable gift of $100 cash will cost the donor $54 after the donation tax credit (at the top marginal tax rate of 46%), but a gift of $100 in shares will cost only $40. The donor will have paid $40 for the shares initially, but will receive a donation tax credit of $46. Granted, the donor is foregoing the benefit of the increase in value of the security (from $40 to $100), but the donor is also avoiding the tax on that increase ($14). “This seems like too good a deal for Canadians not to respond to in a major way,” says Drummond. “First, if there is an option, it is much more cost-effective to donate securities rather than cash. Second, total giving should increase greatly. The donor gets to determine where the money goes (provided it is a registered public charity), yet pays well less than half the cost.”

[12] The Budget Plan documents assert that this tax assistance is even greater than that afforded by the United States.

TAX ASSISTANCE FOR CHARITABLE DONATIONS BY INDIVIDUALS Of Cash Compared to Donations of Publicly Traded Securities			
	Type of Donation		
	Cash	Publicly Traded Securities Donated to Public Charities	
		Current Regime	Conservative Proposal
Fair Market Value of Donation	$100.00	$100.00	$100.00
Top Marginal Tax Rate	46%	46%	46%
Value of Charitable Donations Credit (A)	$46.00	$46.00	$46.00
Typical Cost Base of Security		$40.00	$40.00
Capital Gain on Security		$60.00	$60.00
Capital Gain Tax if Sold, not Donated		$14.00	$14.00
Tax Saved Due to Incentive (B)		$7.00	$14.00
Total Tax Assistance (A + B)	$46.00	$53.00	$60.00
Cost of Donation to Donor	$54.00	$47.00	$40.00
Reproduced with permission from TD Bank Financial Group, TD Economics Special Report dated February 8, 2006, by Don Drummond. Original Source: Department of Finance			

Many members of the charitable sector lobbied to have these measures extended to gifts of publicly traded securities to private foundations, but the current restriction to donations to charitable organizations and public foundations remains.[13] However, the government indicated in the Budget that it will consult with the sector to develop self-dealing rules to safeguard against potential conflicts of interest.

[13] See section 51 of *Notice of Ways and Means Motion to Implement Certain Provisions of the Budget Tabled in Parliament on May 2, 2006* (May 8, 2006) amending paragraph 38(a.1).

D. CONCLUSION

The government expects that the new measures will result in an increase of about $300 million in annual donations. Given the substantial tax benefit of avoiding any capital gains tax on donations of publicly listed securities and ecologically sensitive land, it is important for charities and their advisors to become familiar with the impact of these changes in order to ensure that donors properly understand the tax consequences of choosing to donate such property. In addition, it is recommended that organizations which have not developed a policy in respect of receipt of donations of publicly traded shares do so at their earliest opportunity, taking into consideration the guidance provided in *Registered Charities Newsletter No. 2 (Spring 2002).*[14] Generally, such a policy will require that the donor instruct their broker to transfer the shares directly to an investment account which the charity has set up with their own broker and that the transaction be carried out electronically where possible. CRA has indicated that as a general rule, the date of a gift of electronically transferred shares is the date the shares are received in the charity's account. For the purposes of valuation, CRA has also, as a general rule, accepted the use of the closing bid price of the share on the date it is received or the mid-point between the high and the low trading prices for the day, whichever provides the best indicator, given the circumstances, of fair market value on normal and active market trading. Any policy with respect to receipt of publicly traded shares should deal with these issues, as well as consider under which circumstances the organization might refuse to accept such a gift, for example where the business or activities of the corporation conflict with objects and values of the organization.

[14] Available at http://www.cra-arc.gc.ca/E/pub/tg/charitiesnews-12/news12-e.html.

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