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What Works, Why and at What Cost?
Tax Credits and Capital Gains Strategies

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PART I:
AN OVERVIEW OF TAX CREDITS FOR CHARITABLE DONATIONS AS A PHILANTHROPIC INCENTIVE IN CANADA

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A. INTRODUCTION

- **Canadian registered charities and other “qualified donees” can issue tax receipts to donors to be utilized as non-refundable tax credits for individuals and tax deductions for corporations**
- **The impact of tax credits on charitable giving in Canada has generally more to do with competing tax policies than achieving efficiency in tax incentives**

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B. HISTORICAL BACKGROUND

- **1917 – unlimited deductions from taxable income for donations to the Patriotic and Red Cross funds**
- **1930 – permitted deductions for donations to charitable organizations in general, up to 10% of net taxable income**
- **1957 – optional standard $100 deduction made available without receipts but was repealed in 1984**
- **Ceiling for percentage of income was raised to 75% of taxable income in 1997**

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- **Carryovers were introduced in 1957 to allow excess deductions to be carried forward**
- **Today taxpayers can claim a charitable donation in the year of the gift or in any of the following five taxation years**
- **1966 – the Carter Commission Report recognized the inequity of the tax deduction system**
- **1967 – creation of the central registration system for charities**

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C. HISTORICAL DEBATE OVER DEDUCTIONS V. TAX CREDITS

- **Deductions were seen as regressive because income tax is levied at a progressive rate, i.e. taxpayer at highest marginal rate of tax will receive a greater tax benefit than a taxpayer who is at a lower marginal rate**
- **Carter Commission recommended the continuation of the deduction system because of fears of loosing support of high income earners**

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- **During 1970's and 1980's, academic criticism of the tax deduction system continued because deductions were not seen as consistent with a tax expenditure system**
- **As well, tax deductions were seen as resulting in inequities between high and low income earners**
- **1988 – the tax deduction system for charitable donations was converted into the existing tax credit system**

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D. THE MECHANICS OF THE TAX CREDIT

- **Fundamental aspect of the tax credit is that it is a credit calculated as a percentage of charitable donations made and then subtracted from tax-payers total tax payable**
- **Possible options in implementing a tax credit system**
  - **Flat rate**
  - **Progressive rate**
- **Canada opted for a progressive rate but limited it to a two-tier system only**
- **Tax credit applies only to individuals, but not to corporations**

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- **It is a non-refundable tax credit**
- **On the first $200 of donations, a credit at the lowest marginal rate applies, i.e. currently 15% (21.05% combined rate in Ontario)**
- **For donations in excess of $200, the tax credit increases to the highest marginal rate, i.e., currently 29% (46.41% combined rate in Ontario)**
- **Both high and low income earners receive the same tax credit for the same donation**
- **On its face, therefore, the tax credit would appear to be more equitable**

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E. OBSERVATIONS ON TWO-TIER TAX CREDIT SYSTEM

- **For low income earner, the first tier of tax credit is like a deduction and becomes an incentive for gifts in the second tier**
- **For taxpayers at the top marginal rate, the tax credit at the first tier will be approximately one-half of a deduction, but will become the equivalent of a full deduction for gifts in the second tier**
- **Therefore, donations under $200 will have approximately 50% less tax credits than donations above $200**

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- **As such, the two-tier tax credit system favours tax payers in the higher income bracket**
- **The use of the highest marginal rate for the upper tier was likely chosen to maintain tax incentives to wealthier tax payers, while use of the lowest marginal rate may have been used to offset the general cost of the upper-tier tax credit**
- **In 2005, the forgone tax revenue from tax credit was $1.6 billion, and would have been higher if not for the lower tier tax credit**

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F. THE EFFECT OF THE TAX CREDIT AS A PHILANTHROPIC INCENTIVE

- **Statistical trends of charitable donations between the mid 1980's and early 1990's do not indicate any major shifts in the trend of charitable donations received after the introduction of the tax benefit system**
- **Between 1984 and 1990, the average annual rate of total donations increased by 4.6% but with no major increase between 1987 and 1988**
- **As well, there was no major change in distribution of charitable donations by income group**

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G. CONCLUDING COMMENTS

- **Moving from a tax deduction system to a tax credit system has not resulted in increased giving in Canada**
- **To the extent that the tax deduction was seen as inequitable between income groups, the introduction of a two-tier system utilizing the lowest and highest marginal rates with the change of rates occurring at $200 has in essence perpetuated the percieved inequity**

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- **e.g., Low income earners who give small amounts receive a credit at the same rate that they would have received as a deduction and high income earners who give more will get a tax credit at the same rate as what they would have received as a deduction**
- **As such not, much has changed in Canada**
- **A flat rate tax credit would make for a more equitable tax credit system**
- **There has been a sector proposal made in 2009 to provide an enhanced 50% tax credit for the first $15,000 of additional donations above donations made in 2008**
- **This proposal was not included in January 2009 Federal Budget**

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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

- **Exemption from capital gains tax has been used as an effective incentive for philanthropy in Canada over the last two decades**
- **Capital gains inclusion rate is currently 50%**
- **Capital gains is not taxed until the property is sold**
- **However, gifts of capital property are deemed to have been disposed of at FMV**
- **A donor of capital property is permitted to elect any value between ACB and FMV for determining the proceeds of disposition and the amount of the gift**

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B. DONATION OF PUBLICLY TRADED SECURITIES

- **What is included**
  - **Publicly traded securities (defined technically under the *Income Tax Act* as "listed securities") include a share, debt obligation or right listed on a designated stock exchange, a share of the capital stock of a mutual fund corporation, a unit of mutual fund trust or related segregated fund trust or a prescribed debt obligation**
  - **This definition has in effect been broadened to include listed securities that are donated within 30 days of being acquired under (a) an employee stock option plan or (b) through an exchange from unlisted securities**

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- **History of the exemption**
  - **1997 inclusion rate was reduced by ½ (which was 75% in 1997, 66% in February 2000 and then 50% in October 2000) for gifts of publicly traded securities to registered charities, except private foundations**
  - **Initially introduced in 1997 on a trial basis for 5 years**
  - **2001, the reduction in the inclusion rate was made permanent**
  - **2006, the inclusion rate was reduced to 0, and therefore eliminated capital gains tax for gifts of publicly traded securities**

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- 2007, the exemption was extended to donations of publicly traded securities to private foundations
- Rational for the exclusion was in part to encourage giving to Canadian charities that were facing competition from more generous tax treatment in the US
- Now clearly more advisable to give shares, receive tax credit and avoid capital gains tax inclusion than to first sell shares, pay tax and donate the remaining proceeds

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- The impact of the capital gains exemption
  - Average value of donations of publicly traded securities quadrupled from 1997 to 1999 from 606 charities privately surveyed
  - From 1997 to 2000, the total value of donations of publicly traded securities tripled from $60.1 million to $200.3 million
  - The number of donors of publicly traded securities from 1997 to 2000 increased from 500 to nearly 2400

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- It is too early to tell whether the complete elimination of capital gains tax on gifts of publicly traded shares has created a further tax incentive, but the limited evidence to date suggests that it has
- e.g. the number of donations of publicly traded shares doubled from $122 million to $245 million between 2005 and 2006

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C. ECOLOGICAL GIFTS

- An ecological gift is a donation of land or a partial interest in land, such as conservation easement, covenant or servitude
- An ecological gift is exempt from capital gains tax
- However, the recipient of an ecological gift must be an eligible recipient, which if it a registered charity must be approved by the Minister of the Environment (of which there are approximately 190)

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- The land must then be certified to be ecologically sensitive
- The FMV must be certified by the government through the appraisal review panel
- By March 2008, a total of 652 ecological gifts valued at over $379 million had been made in Canada

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D. GIFTS OF CULTURAL PROPERTY

- The capital gains tax exemption for donations of cultural property was first introduced in 1977
- Similar process to gifts of ecological land
- The recipient of the gift of cultural property must be a “designated institution or public authority”, which generally includes museums and art galleries across Canada
- The Canadian Cultural Property Export Review Board must certify the property as generally having significant cultural relevance

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- **The value of the property is also established by the Board**
- **The only statistics available are that between 1992 and 2004, the number of annual applications to the Board ranged from 926 to 1489**

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E. CONCLUSIONS AND THE FUTURE

- **Exemptions from capital gains tax for gifts of capital property would appear to be effective philanthropic incentive in Canada**
- **There has been proposals to extend the capital gains exemption to other capital property**
  - **Real estate**
  - **Private company shares**
- **However, not yet attracted the serious interest of the Canadian government but this may change**

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