

Donating Appreciated Securities

The benefits of making a charitable donation are countless – from helping those in need to the personal satisfaction we feel when giving something back to a cause we feel passionate about. With proper planning, you can reduce your total income tax liability and maximize the value of your donation. In an effort to increase charitable donations, recent federal budgets have fully eliminated the capital gains tax on donations of publicly traded securities to a registered charity⁽¹⁾. Qualified securities include shares, bonds and mutual funds listed on a prescribed stock exchange.

Charitable Donation Tax Credit

As with cash donations, the fair market value of property donated will reduce an individual donor's taxes through a charitable donation tax credit. The maximum donation an individual can claim on his/her tax return each year is 75% of net income. Donations that cannot be claimed in the year can be carried forward for up to five years. For donations in excess of \$200 the tax credit is calculated at the top marginal rate regardless of the marginal tax rate of the donor⁽²⁾.

To encourage donations by bequest, in the year of death the maximum donation that can be claimed is 100% of the deceased's net income. Any donations that cannot be claimed in the year of death can be claimed on the previous year's tax return, also up to 100% of net income in that year.

Donating Securities

If you are planning to make a charitable donation this year, consider this tax-saving strategy. If you've already determined that you will be selling some of your current investments, perhaps to provide cash to fund this donation, you have an opportunity to reduce the tax you would otherwise have to pay on the sale of your investments if instead you donate the investments directly to a charity. Although a donation of property is considered a disposition for tax purposes, as a result of these tax incentives the taxable capital gain realized on a donated publicly-traded security is eliminated. Whether you donate cash or the securities directly, you will receive a tax receipt for the full amount of

Tax Benefit of Donating Appreciated Securities

	Sell Security and Donate Cash		Donate Security	
Tax on disposition				
Capital gain on sale of security	\$50,000		\$50,000	
Taxable portion	50%		0%	
Taxable Capital Gain	\$25,000		\$0	
Income Tax (46%) ⁽³⁾		(\$11,500)		(\$0)
Donation credit				
Charitable donation amount	\$50,000		\$50,000	
Add tax savings from donation (46%) ⁽⁴⁾		<u>\$23,000</u>		<u>\$23,000</u>
Net tax savings		\$11,500		\$23,000
Net cost to donate \$50,000		\$38,500		\$27,000

your donation regardless of the tax treatment of the capital gain.

The table on the previous page illustrates how this special incentive increases the impact of a charitable donation when the property donated is a qualified security instead of the cash proceeds from the sale of a security. The example assumes an individual owns a security with a current value of \$50,000 and a nil cost base. It further assumes that the capital gain realized on the sale is \$50,000 and the entire \$50,000 proceeds are donated to a charity. In the first column, the security is sold and the cash proceeds are donated. In the other column, the security is donated directly to a charity.

As shown, a donation of securities may be preferred over a cash donation of equal value, particularly if you have already decided to dispose of the securities during the year.

This strategy can also be used in the year of death to reduce tax to the deceased and create a significant donation to a charity at a fraction of the cost. In the next example (presented in the table below), we calculate the net proceeds of an investment that is worth \$50,000 and has an unrealized gain of \$20,000. Let's look at how making a \$25,000 donation from this investment

will impact the deceased's tax liability if properly bequeathed in the deceased's will.

By donating half of the investment, the total tax liability on other income realized in the year of death can be reduced. So much so that a \$50,000 investment provides the deceased's estate with after-tax proceeds of \$34,200 but also provides for a \$25,000 donation to a charity. In other words, it costs the deceased's estate only an incremental \$11,200 (\$45,400 - \$34,200) to make a donation of \$25,000 to a charity.

Donations of shares or proceeds acquired through employee stock options

Although the benefit received on the exercise of employee stock options generally represents employment income (and not a capital gain), it is also possible to reduce or eliminate this employment benefit by donating the shares or proceeds acquired through the exercise of employee stock options.

As above, to be eligible for this incentive the option shares must be publicly-traded securities and the shares (or proceeds acquired through the options) must be donated to a qualifying charity.

Tax Benefit of a Donation Upon Death				
	No Donation		Donation of Half of the Account	
	Current value of investments		\$50,000	
Capital gain	\$20,000		\$20,000	
Taxable portion	\$10,000		\$5,000 ⁽³⁾⁽⁵⁾	
Income Tax (46%) ⁽³⁾		(\$4,600)		(\$2,300)
Net Cash		<u>\$45,400</u>		<u>\$47,700</u>
Donate half of the investments				
Less charitable donation amount				(\$25,000)
Add potential tax savings (vs. other income) from donation (\$25,000 @ 46%) ⁽⁴⁾				\$11,500
Net cash to the deceased's estate				\$34,200
Net cash to charity				\$25,000

The stock option benefit must also be eligible for the 50% deduction available on the qualified exercise of certain securities. Assuming these qualifications are met, the reduced income inclusion is available if the shares are donated in the year acquired within 30 days after the option exercise. In addition, in the case of a “cashless exercise”, the reduced income inclusion may also be available if the employee directs their broker to immediately dispose of securities acquired from the employee stock options and deliver the proceeds to a qualifying charity. Note that if the value of the shares decrease in the above (maximum) 30-day period before donation or if only some of the shares (or aggregate proceeds) received by exercising the options are donated, the tax deduction will be reduced proportionately.

As the tax rules for employee stock options and the related rules used to determine the charitable donation credits are complex, please consult with your tax advisor to determine the appropriateness and the proper implementation of this strategy in your situation.

Donating Flow-Through Shares

A popular strategy post-March 2006 in light of the elimination of the capital gains tax liability on qualifying donations of publicly-traded securities was the donation of (publicly-traded) flow-through shares which typically have a low or nil tax cost base.

A flow-through share structure allows a company incurring eligible resources expenses to renounce (or flow-through) the expenses to the investor who can claim these expenses to offset their taxable income. As a result of the deductions claimed, the investor will generally have a tax cost base of nil on the underlying securities which are often exchanged (on a tax-deferred basis) for a publicly-traded security, such as a mutual fund. Once publicly traded, these investments became excellent candidates for a

qualifying donation as a means of avoiding the significant capital gains that would otherwise be taxed on the eventual sale.

To the extent that the flow-through investment vehicle maintains its market value at the time of donation equal to its original cost, the combined savings of the resource deductions and charitable donation receipt can significantly reduce the after-tax cost of the donation.

However, the 2011 federal budget proposed to limit the future tax benefits associated with this strategy by restricting the exemption from capital gains tax on the donation of flow-through investments to the excess of the (cumulative) capital gains over the original cost of acquiring the flow-through investments. Therefore this strategy may no longer be as attractive in the future.

Given that these budget proposals are still in draft form, it is imperative that anyone contemplating a donation strategy using flow-through investments consult with their tax advisors to confirm the anticipated tax results. In addition to the concerns regarding the recent proposals which may restrict the donation incentives, the renounced expenditures claimed from the flow-through investment may create other tax issues, such as the application of alternative minimum tax which will reduce the current tax benefit of the deductions.

Furthermore, particularly in situations where a flow-through investment is pre-packaged such that the investment is acquired primarily for the purpose of making a gift after a very short hold period, there is a risk that the strategy may be considered a tax shelter which introduces other tax considerations.

Finally, given that flow-through shares are an inherently risky investment, and often impose minimum holding periods for the investor, there is significant market risk such that the underlying

investment may not retain its value thereby reducing the amount of the donation receipt and the overall effectiveness of the strategy. This volatility may also create uncertainty for charities in determining the appropriate valuation for the charitable receipts issued at the time the flow-through securities are gifted.

Corporate Charitable Giving

Corporate charitable giving can also provide the same tax benefits as individual giving, namely:

1. Potential elimination of any capital gains tax on a qualifying gift of publicly-traded securities.
2. Tax deduction equal to the fair market value of the gift.

A corporation will not receive a tax credit for the gifted qualified securities; instead it will be entitled to a deduction equal to the value of the gifted property. This will result in a reduction of the tax that would otherwise be payable on income earned by the corporation.

However, similar to individuals, corporations are also restricted on the amount of charitable deductions claimed annually. A corporation can deduct charitable donations, up to a maximum of 75% of its current year net income, with the potential to carry forward any excess for up to 5 years.

For a Canadian-controlled private corporation, which donates a qualifying publicly-traded security, the 100% non-taxable capital gain portion will be added to the balance of its Capital Dividend Account (CDA). This notional account, when positive, may be paid to shareholders on a tax-free basis which could facilitate the withdrawal of funds from the company to its shareholders.

The table below briefly outlines the tax benefits of donating qualifying securities personally or corporately:

Gift of Qualified Securities	
Individual	Corporation
<p>Federal and Provincial personal tax credits on the gift value:</p> <ul style="list-style-type: none"> • Federal portion is 15% first \$200 and 29% over \$200 • Credits limited to 75% of net income (100% year of death) <p>Capital Gain on qualifying security has 0% inclusion rate.</p>	<p>Corporation may expense the gift value (up to 75% of net income) as a Charitable Deduction.</p> <p>Capital Gain on qualifying security has 0% inclusion rate. Non-taxable portion of the capital gain is added to CDA and a positive balance of CDA may be withdrawn as a tax-free dividend.</p>

Contact your BMO Nesbitt Burns Investment Advisor for more information on donating your appreciated securities. You should also consult with your tax advisor to confirm any potential tax implications associated with a charitable giving strategy since the relevant tax rules can be complex, particularly for corporate giving as the tax rules for corporate donations involve additional considerations.

⁽¹⁾ Or other qualified donees. The 2006 federal budget fully eliminated the capital gains tax on qualifying gifts to public charitable foundations or organizations after May 1, 2006 and the 2007 federal budget extended this incentive for qualifying gifts to private foundations after March 18, 2007.

⁽²⁾ In Alberta, the tax credit for donations over \$200 exceeds the combined top marginal tax rates to provide additional charitable incentives.

⁽³⁾ Based upon an assumed top marginal tax rate.

⁽⁴⁾ Assumes individual has made other donations of at least \$200 in the year and has sufficient other income to avoid the limit on donation claim to 75% of net income (100% in the year of death).

⁽⁵⁾ \$20,000 Total Gain less 50% non taxable due to donation x 50% inclusion rate.