RBC Dominion Securities **Bulletin**

WEALTH MANAGEMENT
Wealth and Money Management
Strategies and Solutions

Wealth Management Services

August 17, 2006

Charitable Donations of Securities

Gifting shares that have appreciated in value can be a tax-effective planning tool

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Gifting Publicly Traded Securities

To encourage individuals to increase their charitable giving, there is a tax incentive for those individuals who wish to donate publicly traded securities (traded on a prescribed stock exchange). These securities would include stocks, rights, mutual funds, interests in related segregated funds, or bonds donated to charitable organizations and public foundations (hereinafter referred to as "charity"). Effective May 2, 2006, the capital gains triggered upon the disposition of the donated securities has been eliminated. The elimination of the capital gain results in lower income taxes.

The donation of publicly traded securities is considered to be a disposition by the donor for Canadian tax purposes. This means that a donation of publicly traded securities to a charity will result in either a capital gain or a capital loss to the donor. However, since May 2, 2006, the taxable capital gain for donated securities is reduced to zero. Note that the donation of publicly listed securities to a private foundation is not eligible for the zero capital gains inclusion rate. In that case, the capital gain inclusion rate will be the normal 50%.

In addition to the eliminated capital gains, a donor also receives a charitable donation tax receipt for the Fair Market Value (FMV) of the donated securities. The donation tax receipt can be used to reduce the donor's income taxes. The amount of the donation receipt that is issued by the recipient charity is usually equal to the FMV of the securities donated at the time that these securities are received by the charity. It is important to note that the charity would have to be willing and able to receive the donated securities in kind. It is advisable to contact the charity to ensure their acceptance of the donated securities when planning to make a donation in kind.

Mechanics of the Tax Credit

When a donation is made to a qualifying charity, the donor is entitled to claim a tax credit on their personal tax return. Some examples of a qualifying charity are Canadian registered charities, Canadian universities, registered Canadian amateur athletic associations, certain universities outside of Canada, and the United Nations. The tax credits reduce the amount of tax that the donor has to pay in a given year by reducing the federal and provincial taxes payable.

For the first $200 of donations being claimed, a non-refundable federal tax credit of 15.25% for 2006 is granted. This means that the amount of federal tax payable is reduced by $31. After the first $200 threshold is passed, any remaining donation amount being claimed on the tax return for that year will result in a non-refundable federal tax credit of 29%. Thus if an individual claims a total of $1,000 in donations, the first $200 will generate $31 in federal tax credits, while the remaining $800 will generate $232 in federal tax credits, for a total of $263 in federal tax credits. The provincial taxes payable are also reduced.

The net effect for taxpayers in all tax brackets is that the portion of the charitable donation in excess of the first $200 will result in a tax savings approximately equal to the top marginal tax rate.

The following table summarizes the highest marginal tax rates for the provinces for 2006:

Province	**Highest Marginal Tax Rate**
British Columbia	43.7%
Alberta	39.0%
Saskatchewan	44.0%
Manitoba	46.4%
Ontario	46.4%
Quebec	48.2%
New Brunswick	46.8%
Prince Edward Island	47.4%
Nova Scotia	48.3%
Newfoundland and Labrador	48.6%
Yukon	42.4%
Northwest Territories	43.1%
Nunavut	40.5%

Combining the Elimination of the Capital Gain and the Donations Tax Credit

When you donate a security with accrued capital gains, you benefit from the elimination of the capital gain plus the donation tax credit. The combined tax savings can be quite impressive. The following example illustrates this point by comparing two alternatives for donating securities with a FMV of $50,000 and an Adjusted Cost Base (ACB) of zero.

	Sell shares and donate cash	**Donate shares directly**
FMV of donation (a)	$50,000	$50,000
Adjusted cost base	0	0
Capital gain	50,000	50,000
Taxable capital gain	25,000	0
Tax on capital gain @46% (b)	11,500	0
Tax savings from donation tax credit (c)	23,000	23,000
Total cost of donation = (a) + (b) – (c)	**38,500**	**27,000**

The two examples above demonstrate that there is a tax savings to be realized by donating publicly traded securities with appreciated gains compared to first selling the publicly traded securities and then donating the proceeds. In the above example, a savings of $11,500 ($38,500 – $27,000) would be realized by choosing to donate the appreciated property instead of selling it and donating the proceeds. <u>The difference is a direct result of the eliminated capital gains on the donated securities.</u>

Other Strategies to Maximize the Tax Benefit of Donations

Several strategies may be combined with the elimination of the capital gains on donated securities to enhance the tax benefits.

DONATE SHARES TO ELIMINATE TAX ON SALE OF SECURITIES

If you are considering selling securities with an accrued capital gain, then you would trigger a tax liability on the taxable capital gain. Donating the securities may be one alternative to eliminating the taxable capital gain. However, you may not wish to donate all the securities since you may want to reinvest the proceeds or use them for lifestyle expenses. In this case, you may want to donate a portion of your securities and sell the remaining portion. As a result, the donation tax credit on the portion of the securities that you donate can reduce the tax liability on the capital gain triggered on the disposition of the remaining portion (i.e. portion not donated). This begs the question, what portion of my securities do I need to donate so that the tax on the securities that I sell will be eliminated? The following formula should be used in order to calculate the FMV of the shares to be donated in order to eliminate the tax on the sale of the securities that you retain:

$$\text{FMV of the Donated Securities} = \frac{(\text{FMV})(\text{FMV} - \text{ACB})}{(3\text{FMV} - \text{ACB})}$$

Here is an example to illustrate assuming a FMV of securities of $50,000 with a zero ACB:

$$\text{FMV of the Donated Securities} = \frac{(\$50{,}000) \times (\$50{,}000 - \$0)}{(3 \times \$50{,}000 - \$0)}$$

FMV of the Donated Securities = $16,667

The following table demonstrates the tax impact of selling the securities and keeping all the sale proceeds of $50,000 vs. donating $16,667 of securities and keeping the remaining $33,333 of sale proceeds:

	Sell securities	Donate a portion and keep the remaining sale proceeds
FMV of securities (a)	$50,000	$50,000
Proceeds of Disposition of securities retained	50,000	33,333
Amount of charitable gift (b)	0	16,667
ACB	0	0
Capital gain	50,000	50,000
Taxable capital gain on securities retained	25,000	16,667 (*)
Tax on capital gain @46% (c)	11,500	7,667
Tax savings from donation tax credit (d)	0	7,667
Net tax liability	11,500	0
Net proceeds retained = (a) – (b) – (c) + (d)	38,000	33,333

(*) 50% of capital gain on securities retained = $33,333 x 50% = $16,667

The taxable capital gain on the $16,667 securities donated is nil.

Based on the above example, you could donate securities worth $16,667 at an out of pocket cost to you of $4,667 [$38,000 - $33,333]. The donation tax credit of $7,667 will eliminate the tax on the capital gain of $7,667 on the securities that you sell and thus you will have a net tax liability of zero. This would be a great strategy to support a charity and keep a portion of the proceeds to reinvest or for lifestyle expenses.

DONATING FLOW THROUGH SHARES

The tax benefit of donating securities is enhanced when a mutual fund that was originally a flow through share is donated to a charity. When you invest in a flow through share, you are generally able to deduct expenses allocated by the flow through company up to a maximum equal to the amount you paid for the flow through share. For example, if you purchased a flow through share for $10,000, then you may receive deductions equal to $10,000 (possibly over 2-3 years). At a marginal tax rate of 46%, this would generate a tax savings of $4,600. As a result, your ACB would be reduced by the amount of the deduction which in our example results in a zero ACB. After 18-24 months, many of the flow through shares will rollover on a tax-deferred basis to a mutual fund which can then be sold. The mutual fund would have a zero ACB (rolled over from the flow through share). Upon disposition of the mutual fund, you would trigger a capital gain equal to its FMV. If you donate the mutual fund to a charity, you would benefit from the eliminated capital gain and the charitable donation credit.

Let's illustrate using an example:

	Sell flow through/mutual fund and donate cash	**Donate flow through/mutual fund directly**
Flow through acquisition (a)	$50,000	$50,000
Deductions claimed	(50,000)	(50,000)
Tax savings @ 46% (b)	23,000	23,000
FMV of donation	50,000	50,000
Adjusted cost base	0	0
Capital gain	50,000	50,000
Taxable capital gain	25,000	0
Tax on capital gain @46% (c)	11,500	0
Tax savings from donation tax credit (d)	23,000	23,000
Total cost of donation = (a) – (b) +(c) – (d)	15,500	4,000

It is important to note that some flow through shares do not trade initially on a prescribed stock exchange and hence will not qualify for the eliminated capital gains treatment if they are donated. Typically, you would have to wait until the flow through shares are converted into a mutual fund which may then be donated in kind to receive the favourable tax treatment.

DONATING SHARES ACQUIRED THROUGH EMPLOYEE STOCK OPTIONS

The favourable tax treatment concerning the donation of securities extends to the donation of stocks acquired through employee stock options when the securities are donated to a charity. When stock options are exercised, a taxable **employment** benefit would be generated equal to the difference between the FMV on the day of the exercise and the exercise price. The taxable benefit may be reduced by 50% if certain conditions are met. If the securities are donated to a charity in the same year of the exercise and within 30 days of exercise, then the taxable benefit would be eliminated. The FMV of the securities would also generate a donation tax credit.

Note that if you have a cashless exercise where you exercise your options but direct a broker that your employer uses to immediately sell the stock and donate the sale proceeds to a charity in the same year of exercise or within 30 days after exercise, then you will also be eligible to eliminate all or a portion of the taxable stock option benefit.

COMBINING CHARITABLE DONATION TAX CREDITS

Charitable donation receipts made out to one spouse can be used on either spouse's tax return. This may present an opportunity where several donations can be collected together to maximize the amount of the tax credit at the top marginal tax rate.

Maximum Tax Credits

For most types of donations, an individual can claim charitable contribution tax credits equal to a maximum of 75% of net income in a taxation year. Where donations are made in the year of death, this limit is raised to 100% of net income. If there are excess unused credits in the year of death, then the preceding year's tax return can be refiled to also claim a tax credit of up to 100% of that year's net income.

The ability to claim a tax credit equal to 100% of net income in the year of death can be advantageous for individuals who plan to donate their RSP or RIF to a charity upon their death. The tax credit for the charitable contribution could offset the income inclusion that would be required upon the deemed deregistration of the RSP or RIF. That is, the RSP/RIF income inclusion would generally be taxed at the top marginal tax rate on the terminal tax return but this would be offset by the RSP/RIF donation tax credit which is also at the top marginal tax rate.

Note: The above information is based on the tax law in effect as of the date of this article. The article is for informational purposes only and should not be construed as offering tax or legal advice. Individuals should consult with a qualified tax and legal advisor before taking any action based upon the information contained in this article.