DONATION DRILL

CHARITY CAN BEGIN WITH SIGNIFICANT TAX SAVINGS.

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Nearly **5.8 million** Canadians claimed donations to various registered charities on their 2006 tax returns. Such donations are actually encouraged by the federal government, which even ran a media blitz last month that included ads in more than 75 daily newspapers across the country touting the CRA's Charities Listings (www.cra.gc.ca/donors). The listings let potential donors verify that a charity is legit and registered, and therefore will entitle the donor to a donation tax credit.

The Basics

The amount an individual donates to a charity is eligible for both federal and provincial donation tax credits. For the first $200 of donations made in a calendar year, the federal donation credit is equal to 15% of the amount given, while the provincial/territorial credit varies from 4% to 11%.

But it gets better. Once an individual has made at least $200 of donations in any year, the donation credit jumps to 29% federally, plus between 11% and 21% provincially, depending on the donor's income tax bracket and whether he or she is subject to various high-income surtaxes levied by some provinces.

So, for donations in excess of the first $200, a donor would get back a minimum 40% of the amount donated. Given the donations are in the form of tax credits (a reduction of tax owing) as opposed to tax deductions (a reduction of taxable income), the credits are essentially worth the same for clients with low, middle, and high incomes (provided you don't factor for the effect of any provincial surtaxes).

Donating Securities

Perhaps the most tax-effective way to benefit a registered charity is by donating appreciated marketable securities. The government's May 2006 federal budget completely eliminated the capital gains tax on donations of listed shares, mutual funds and segregated funds to registered Canadian charities. And the 2007 federal budget extended this rule to donation of eligible appreciated securities to private foundations.

Donors have been taking full advantage. A 2007 study by Craig Alexander, vice-president and deputy chief economist with TD Economics, titled "*Donating Securities Makes Good Financial Sense*," demonstrates the increased potential for this type of charitable giving due to the tax benefits.

According to TD Economics, Canadians owned shares with a fair market value of $1.4 trillion at the end of 2006, of which approximately $700 billion represents unrealized capital gains. If even a small portion of these outstanding shares were donated to charity to reduce the owners' tax **continued on page 31** continued from page 29 liabilities, the impact on Canadian charities would be tremendous.

For example, with Bell Canada (BCE) stock set to go private by the end of this quarter, clients who are sitting on holdings with significant accrued capital gains have an opportunity to do some proactive tax planning. Investors who hold shares that have appreciated substantially outside of a tax-sheltered plan such as an RRSP or RRIF may face a huge tax liability shortly, when their stock is bought out from under them.

But if your client is philanthropically inclined, sowing the seeds of tax planning today can reap huge rewards in the form of tax savings this year, and potentially for up to five years ahead.

Consider this scenario: John owns $30,000 of BCE shares that he inherited years ago from his great aunt. At the time of her death, the fair market value of the shares was only $6,000, so that became John's adjusted cost base (ACB) or tax cost.

John generally donates about $5,000 annually to charity, which he divides equally among four of his favourite causes. Given that BCE shares won't be around for much longer, he may wish to act quickly and take advantage of this tax-planning opportunity.

Let's say he donates his entire $30,000 cache of BCE stock this year by giving $7,500 worth of shares to each of his four selected charities. He'll immediately save the capital gains tax on the $24,000 accrued gain, equal to about $5,000 of tax, assuming a marginal capital gains tax rate of approximately 20%.

But that's not all. John will receive four donation receipts totalling $30,000 which will produce a tax savings to him of at least 40%, regardless of which tax bracket he's in.

While the charities benefit this year from the increased donations, John can either choose to claim the entire $30,000 donation credit on his 2008 return, or he can spread out his donation credits by claiming them over the next five years—the maximum carry-forward allowed for charitable donations. Naturally, John would only do so if he were unable to use the full value of the donation credit in the current year to reduce his tax payable to zero.

Demutualization Shares

Another opportunity to really maximize the value of these new rules is to donate shares your client may have received from an insurance demutualization back in 1999 and 2000, and which have an ACB, or tax cost, of zero. Ordinarily, your client would pay tax on half of any proceeds received. But by donating these shares to charity, he or she would pay no tax at all and get a tax receipt equal to the shares' current fair market value.

Let's take the example of two clients, Jack and Louanne, who each wish to make a $5,000 donation to their favourite charities. We'll assume each of them owns $5,000 worth of shares of Industrial Alliance (IAG) that they received through its insurance demutualization back in February, 2000. Those shares have performed well and so with an ACB of zero, they make an ideal candidate for this program.

Louanne, being a collector of frequent-flyer miles, decides to make her charitable donation using her Visa card since she can accumulate one mile for each donation dollar given to the charity.

She'll receive a $5,000 tax receipt for her donation (and get 5,000 travel miles). The ACB of her untouched IAG shares, however, remains constant at zero. Assuming a combined federal and provincial donation tax credit of 40%, her donation receipt would generate $2,000 of tax savings.

Jack, on the other hand, decides he wants to continue owning the IAG shares but would still like to make his donation in-kind in order to maximize the tax opportunities. He would pay no capital gains tax at all on donation of the shares to charity, but would still be entitled to his full tax receipt for the $5,000 contributed, worth the same $2,000.

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Since Jack wants to continue to own the IAG shares, he simply buys them back on the open market. By doing so, he'll bump his ACB to the current fair-market value of $5,000, meaning he would only pay capital gains tax on any future appreciation. Keep in mind Jack need not wait thirty days before buying the stock back, as there's no superficial gain rule in the Income Tax Act.

The result? Both Jack and Louanne have each made a $5,000 donation and continue to own IAG shares. While Louanne has accumulated 5,000 air miles, Jack has just saved future capital gains tax of $1,000 ($5,000 x 50% x 40%).

RRSPs and RRIFs

But what if your client holds her appreciated shares inside her RRSP or RRIF? Unfortunately, the new rules eliminating capital gains tax on securities donations are of little relevance to those wishing to donate securities held in registered plans. The moment those funds are withdrawn, the continued on page 33 continued from page 31 fair market value of the withdrawals is immediately taken into income at full marginal rates.

What's perhaps been overlooked, however, is a planning opportunity that's always been available should your client wish to donate a portion of her RRSP or RRIF to charity. (This opportunity works best if she's not in the top tax bracket, which kicks in at income over approximately $124,000 for 2008.)

Say your client wants to donate $1,000 of stock from her RRSP to charity. She'll face tax on the $1,000 withdrawn at her full marginal tax rate but will also be entitled to a donation receipt equal to $1,000. For someone in the top tax bracket, it's a simple in-and-out. (The tax on the RRSP withdrawal will be offset by the donation tax credit.)

For everyone else, however, because a donor is entitled to a donation credit at the highest rate for any donations over $200 per year, the credit can exceed the tax on the RRSP withdrawal. This lets the donor use the remaining donation credit to offset other income.

Let's assume Morty is retired and living on about $25,000 a year in income from his investments. This puts him in a 21% tax bracket in Ontario. Assuming he's already made $200 worth of donations during the year and then makes a special donation of $1,000 from his RRSP, Morty would pay $210 of tax on the RRSP withdrawal but he would also receive a tax receipt for $1,000, which is worth just over 40% or $400.

In other words, by donating $1,000 of RRSP money to charity, he not only withdraws the funds tax-free but also gets an additional $190 ($400 - $210) of tax credits, which can then be used to reduce taxes on his investment income.

Gifting Life Insurance

Another way to give involves donation of life insurance. There are two main ways this can be accomplished.

The first is to buy a policy naming the charity as the beneficiary. This provides your client with the most flexibility, as he can always change his mind and replace the beneficiary. If the charity remains the ultimate beneficiary upon your client's death, it will receive the death benefit and your client's estate would be entitled to the donation tax credit equal to the value of the policy.

In the second method, the charity actually owns the policy on the client's life, naming itself as the irrevocable beneficiary of the policy. Each year, the charity will issue your client a donation receipt equal to the value of the life insurance premiums she has paid. The downside? Your client can't change her mind should she have second thoughts about the worthiness of the charity.

Beware Gifting Shelters

Finally, two quick words on those donation tax shelters that continued to attract clients' attention over those last weeks of 2007—be careful!

Last August, the CRA urged Canadians to be wary of such donation gifting arrangements, which tend to promote tax savings in excess of the amounts donated.

These shelters often involve a donation of property, such as medical supplies or computer software, to a registered charity. According to one promoter, the donor gets a receipt "equal to the appraised fair market value of the property donated to the [charity]. The fair market value of the property has been substantiated by an independent appraisal. A donor may request a copy of this appraisal by contacting [the promoter]."

But just because you have an independent appraisal doesn't mean that you're home free when it comes to defending the fair market value before the CRA. The CRA has been aggressively challenging, and winning, many of the tax shelter cases in the last few years on the basis of inflated valuations.

For example, in November 2005, the Federal Court of Appeal released its now infamous decisions in a trio of tax shelter cases (*Nash*, *Tolley* and *Quinn*). The basic facts of all three were similar and involved the donation of art to charity. The CRA won all three cases.

In April 2006, the Supreme Court of Canada denied leave to appeal in these cases, striking a further blow to donation tax shelter participants. Thousands of Canadians, unfortunately, continue to be enticed by the allure of what appears to be easy money. But the CRA is slowly catching up to them.

According to statistics released by the government last summer, the CRA has so far audited more than 26,000 people who've participated in these tax shelters and, as a result, about $1.4 billion in claimed donations has been denied. The CRA will soon complete audits of another 20,000 taxpayers, involving close to $550 million in donations, and is about to begin auditing another 50,000 taxpayers who have participated in tax shelter gifting arrangements.

As former National Revenue Minister Carol Skelton warned: "If it sounds too good to be true, don't fall for it. Taxpayers need to know that the Canada Revenue Agency is auditing all tax shelter gifting arrangements."

And, in late November 2007, the CRA took a bold step by suspending a registered charity for one year for "failing to maintain and/or provide, and failing to provide access to books and records relating to its involvement with tax shelter arrangements." In other words, warn your clients so they don't get sucked in. AE

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