A Framework to Evaluate Tax Incentives for Charitable Donations

A Submission to

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Introduction

The Finance Committee's hearing on tax incentives for charitable donations is a unique opportunity to review tax policy related to charitable gifts in Canada. I am grateful for the invitation to participate in this process.

By way of introduction, I am a charitable gift planner and Head, Philanthropic Advisory Services at Scotia Private Client Group, which is part of Scotiabank. I worked at three large Toronto charities for 13 years prior to joining Scotiabank in 2004. Scotia Private Client Group facilitates charitable donations from private clients in excess of $100 million per annum. We are the largest national service provider to private foundations and operate Aqueduct Foundation, a public foundation.

My interest in charitable tax policy stems from my work with private clients as they plan significant lifetime and legacy gifts, as well as my 15-year involvement as a volunteer in the charitable sector. I have been fortunate to contribute to the debate on charitable policy through the Canadian Association of Gift Planners, Imagine Canada, *The Philanthropist* journal, CRA's Charities Directorate, and the C.D. Howe Institute.

I have been closely involved with the development of three proposals being considered by the Committee. They are the Stretch Tax Credit (as chair of Imagine Canada's committee that developed the proposal) and the elimination of capital gains on taxable real estate and private securities (published through the C.D. Howe Institute). I believe, however, my best contribution to this process is to comment on what constitutes good charitable tax policy and incentives.

Specifically, I would like to make observations on the following:

1. state of Canadian donation incentive regime in the Income Tax Act;

2. limits of tax incentives for donations;

3. three factors to evaluate charitable tax incentives.

My intent is to assist the Committee by providing a practical framework to evaluate charitable tax incentives in general to help create the best possible donation incentive system in Canada. The framework provides a context for my support of the proposals for the Stretch Tax Credit and elimination of capital gains on gifts of public securities and taxable real estate.

State of Canadian donation incentive regime in the Income Tax Act

Due to changes made to the Income Tax Act since 1996, Canada arguably has the most generous regime of donation tax incentives in the world. There are a number of factors that make the Canadian system a leader.

1. Tax Credits: Since 1988 individual taxpayers in Canada receive tax credits for donations, not deductions. While tax credits are poorly understood, they are more beneficial than deductions for the majority of Canadian donors. For example, a B.C. taxpayer with a $65,000 net annual income has an average tax rate of 20.5 percent. This taxpayer would receive a combined federal/provincial tax credit of 20.1 percent for donations under $200 and 43.7 percent for any donation over $200. By contrast, the U.S. deduction system limits the donation tax benefit to the rate of tax owing. Generous Canadian middle-income earners receive a bonus for donations over $200.

2. Contribution Limit: Canada has the highest donation "contribution limit" in the world. Taxpayers may claim lifetime gifts equal to 75 percent of annual net income and 100 percent at death. During life there is a five-year carryforward of unclaimed receipts and, at death, a one-year carryback. Charitable Canadians can offset up to 75 percent of their annual taxes by giving to registered charities. At death, income taxes can be entirely eliminated. By contrast the U.S. limits range from 20 to 50 percent of income depending on the asset donated and recipient charity. The contribution limit facilitates exceptional gifts – "major gifts" or "planned gifts" – from assets, not ordinary gifts from income.

3. Donations of Capital Property: Canada has extra incentives for gifts of certain types of capital property. Gifts of public securities, employee stock options, exchangeable shares, ecological land and cultural property are all exempt from capital gain (or equivalent employment benefit) when donated to charity. Capital gains exemption provides a second level of tax benefits for a donation. An individual who donates certain capital property first receives a tax credit of 43 to 50 percent (depending on the province) and up to 25 percent due to the elimination of capital gains (depending on the province and capital gain on the property donated). Incentives for gifts of capital property have become a key part of the Canadian donation regime. In the interest of equity among taxpayers, the elimination of capital gains could be expanded to include taxable real estate and private securities.

The Income Tax Act has an extensive regime of charitable incentive. I am of the view that it is a mature system with few opportunities for expansion. While there are important incentives that could still be introduced, we are reaching the limit of what the tax system can and should do to encourage donor generosity.

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Limits of donation tax incentives

The introduction of the tax deduction for donations in 1917, which was institutionalized with the tax receipt in 1967, has meant that charitable gifts in Canada are often viewed as tax transactions. This perspective is misleading. Charitable gifts are not primarily tax motivated. Tax incentives are a blunt instrument in encouraging gifts to charity.

1. **Role of Altruism:** Gifts are defined as "freely given without consideration" in common law. Gifts are characterized by the donor's impoverishment. Donors give because they wish to confer a benefit to a charity to advance its charitable objects. Our tax system is based on the principle of offset: the tax benefit for donations offsets the taxes owing. Despite the structure of tax credits, the tax system is not intended to provide extra enrichment for making a gift. Excessive tax benefits undermine the principle of philanthropy, which is important Canadian value.

2. **Donor Motivation:** Philanthropic research has consistently found that donors place tax benefits low on the list of motivations. The effectiveness of the charity, the donor's personal values, and relationship to the charity consistently rate higher. Who makes the solicitation also influences donation decisions. For example, when your 10-year-old niece asks you to sponsor her in a charity event, tax does not enter into the calculation. Statistics Canada reported that the median donation was $260 in 2010, but for most individuals this figure is a sum of a number of small donations motivated by different social and philanthropic reasons. Tax savings do not typically influence each gift. Additional tax benefits for the "average" donor have the potential of inflating tax expenditure with little effect on donor behavior. The elimination of the first $200 donation tier, for example, would cost the Federal Government an extra $80 to $100 million per annum for *existing* behavior with no guarantee of new giving.

   A case in point: in 2007, the Province of Alberta raised its provincial tax credit for donations from 10 percent to 21 percent. Donations of more than $200 now receive 50 percent credits in Alberta and the province's marginal tax rate is 39 percent. This is the highest individual donation benefit in Canada. It should have prompted a significant jump in donations in Alberta relative to other provinces. Yes, Alberta has been a one of leaders in Canadian giving in the last four years. According to Statistics Canada, however, for two of the last four years Alberta was second to B.C. in growth in value of donations. Manitoba beat Alberta in donor participation numbers for all four years. Neither B.C. nor Manitoba have extra giving incentives.

3. **Gifts of Assets:** Tax incentives for gifts of assets, such as capital property, are most effective. Gifts of assets are exceptional – as opposed to everyday or annual gifts – and require planning to implement. Through the planning process the tax implications become better understood. The majority of the approximately 20 donation incentives introduced into the Income Tax Act since 1996 focused on this category of gifts. For example, the elimination of capital gains on gifts of public

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securities unlocked a class of assets for donation purposes. Donor behavior altered, which is reflected by the increase in average donation over the last 15 years. New wealth came into the charitable sector. Tax planning has a greater influence on gifts of assets; tax incentive for these gifts result in the highest return on tax expenditure. Big donations of assets, however, are typically made to larger, more established charities. These incentives unlock large donations, but the distribution is not equitable across the charitable sector. Due to the element of personal choice, this is characteristic of charitable giving by private donors.

Three factors to evaluate charitable tax incentives.

The discussion of charitable tax benefits typically focuses on incenting donors. The assumption is that tax incentives will produce more gifts for charity, and, *de facto*, all Canadians will benefit. The reality is not so simple. A valid charitable tax incentive must meet the following tri-partite test:

1. **Produce "return on investment" for Government tax expenditure and safeguard the tax system.**

As previously discussed, donation tax incentives should produce greater public return relative to the amount invested by the Federal and Provincial governments. The current system is grounded in the concept of a tax offset for donations. Tax is offset by the charitable credit is made in acknowledgement of the public benefit of the donation. The "offset" model should be maintained unless there is clear evidence that a measure will prompt behavioral change and bring new dollars to charities.

The second issue for the Federal Government is safeguards. Will an incentive be so complex that it is susceptible to valuation abuse? Will tax expenditure match public benefit? Incentives for capital property, in particular, need to meet this test.

2. **Incentive for donors.**

In my experience, donors respond to tax incentives when the gift amount is personally material and there is planning involved. Spontaneous donations are rarely made because of tax savings alone. The tax system should never forget that giving involves, well, giving something up. The incentive must be sufficient to change behavior, but not so great that it becomes the exclusively tax motivated

3. **Reasonable risk and return for recipient charities.**

There are currently 86,000 registered charities in Canada. Two-thirds have annual revenue of less than $100,000 per annum and are volunteer run, yet the tax system assumes that all charities are equally capable of receiving and managing all gifts.

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While all charities can manage cash gifts, gifts of more complex property strain the vast majority of charities.

For example, few charities have expertise or resources to value or manage a gift of industrial building or a condo in Florida. Creating incentives that encourage complex property donations places a burden on charities and takes resources away from the pursuit of their charitable purposes. Hence, complex property donation incentives must be designed to reduce the burden on charities. The history of charities being taken advantage of by tax shelter promoters underscores this vulnerability.

This is why I originally propose the elimination of capital gains on the majority of gifts of taxable real estate be predicated on the donor selling the real estate and donating cash proceeds within 30 days. Charities want the cash to pursue their mission, not the liability and management challenges of owning real estate. This mechanism may reduce the number of potential donations of real estate, but it will increase the value of the gifts and safeguard the tax system due to certainty of valuation (receipt is based on cash received). Especially with gifts of capital property, it is important for the tax rules to protect as well as support charities.

Conclusion

This evaluative framework is based on my prior research and publications and is intended to contribute to debate to design the best possible donation incentive system for Canada. Applying these criteria to the proposals under consideration, I have the following comments:

1. Imagine Canada's Stretch Tax Credit is a credible proposal to incent ordinary donor to change behavior and contribute more to charity, without creating systemic inflation of tax expenditures.

2. Eliminating capital gains on taxable real estate is the strongest option among the capital incentives. The incentive should only be adopted if the majority of donations will be of cash proceeds within 30 days of the sale of real estate and a mechanism is introduced to allow in-kind donation in special circumstances.

3. Eliminating capital gains on private company shares will potentially unlock the largest untapped source of wealth for the charitable sector. Valuation of these securities is the central challenge. The existing five-year monetization rule can be built upon to ensure safeguards for charities and the tax system.

In closing, Canada has a far-reaching tax incentive system that serves charities and provides significant public benefit. Care needs to be exercised to ensure that any additional measures balance the needs of the Government, donors, and charities.

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