The Case for Tax Incentives on Gifts of Publicly Traded Securities

William I. Innes*

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The introduction in 1997 of a new rule eliminating one-half of the taxable capital gain on gifts of publicly traded securities to charities[1] (and other qualified donees) was met with great enthusiasm in the charitable sector and skepticism by some tax policy analysts. On October 25, 2002, the Department of Finance published the results of the first four years of this program.[2] In my view, those results demonstrate that the program has been highly effective in encouraging gifts to charities, with probably little or no incremental cost in terms of tax expenditure in the charitable sector, and that it should, in fact, be expanded to entirely eliminate the taxable capital gain on such gifts.

THE BACKGROUND

The charitable tax credit system under the Income Tax Act[3] to all intents and purposes operates as a tax deduction.[4] In the case of individuals in the top rate

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1 Other than private foundations.

2 See "Special Federal Tax Assistance for Charitable Donations of Publicly Traded Securities," in Canada, Department of Finance, *Tax Expenditures and Evaluations 2002* (Ottawa: Department of Finance, 2002), 59-74.

3 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

4 Technically, section 118.1 provides a tax credit system for individuals, while section 110.1 provides a tax deduction system for corporations. In the case of aggregate gifts exceeding $200.00 in a taxation year, the two systems operate in basically the same fashion.

bracket, half of the gift comes out of the individual's pocket and half of it comes from the government in the form of the tax saving the individual realizes on the gift.[5] While these percentages vary over time and from province to province,[6] the architecture of the Act is essentially predicated on this deduction model. Where, however, the subject matter of the gift is property with accrued gain, this system tends to break down, and the effective "cost" of the gift to the taxpayer becomes higher because the making of the gift triggers tax on the accrued but unrealized gain.

Paragraph 38(a.1) was introduced into the Act in 1997 in an attempt to encourage gifts of publicly traded securities to charitable organizations and public charitable foundations.[7] The rule now provides that where a gift of a publicly traded security is made to a qualified donee, other than a private charitable foundation, the taxable capital gain on the donation is one-quarter of the capital gain (in contrast to the one-half rate that normally applies in respect of a disposition of capital property).

In order to analyze how this rule works to reduce the "cost" of donations, and thus acts as an incentive to donors, one has to establish appropriate comparables. In the first place, I think one has to assume that most donations are made with the aim of giving a specific amount to the recipient charity; that is, most donors are fulfilling a commitment to give X dollars to the charity, whether in the form of cash or in the form of securities valued at X dollars. Second, I think one has to contrast the case of donors who hold securities as long-term investments with that of donors who hold securities for a short term. In the former case, the economic value of the securities to the donor is close to their full fair market value, since the tax on the accrued but unrealized gain will not be triggered for many years. (For example, in the case of a husband and wife, the tax could be deferred until the death of the survivor.) In the case of short-term investments, the economic value of the securities to the donor is essentially the fair market value less the tax that will be triggered on a disposition.

In the appendix to this article, I have set out examples of the economic cost to donors, and to the fisc, of five types of gift, each of which results in a $100 transfer to a charity:

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5 In the case of the first $200.00 in annual gifts, roughly 76 percent comes from the individual and 24 percent from government.

6 Thus, in Ontario in 2002 in the case of top marginal rate individuals, the government share is 46.41 percent; the individual's, 53.59 percent.

7 SC 1998, c. 19, section 6(1), applicable after February 18, 1997. The provision originally had a sunset clause and would have expired on December 31, 2001. Bill C-49 (SC 2002, c. 9) removed that restriction, and the provision has now become permanent. The original provision was introduced at a time when the capital gains inclusion rate was 75 percent. At that time, the amount of the taxable capital gain for such gifts was three-eighths of the capital gain; when the inclusion rate rose to 66⅔ percent, the amount of the taxable capital gain for such gifts was one-third of the capital gain; finally, when the inclusion rate was reduced to 50 percent (that is, the current rate), the amount of the taxable capital gain for such gifts was one-quarter of the capital gain. In this article, I will deal only with the current provisions of paragraph 38(a.1), although a similar analysis would apply to the earlier incarnations of this rule.

1. a gift of net proceeds after the sale of a security;
2. a gift of a security under the old regime where 50 percent of the capital gain was taxed;
3. a gift of a security under the current regime where only 25 percent of the capital gain is taxed;
4. a gift of a security if none of the capital gain were subject to tax; and
5. a gift of cash.

In the appendix I have contrasted the position of the donation of long-term and short-term assets. The most costly form of donation from the viewpoint of a donor is a donation of the net proceeds of sale of long-term assets. In that case, the donor incurs $33[8] in tax on the sale, gives $100 in cash to the charity, and receives $50 in tax relief, resulting in an effective cost of $83. A gift of long-term assets under the old regime was less costly: the donor gave securities worth $100, incurred tax of $25, and got tax relief of $50, for an effective cost of $75. The current regime improves the donor's position by reducing the tax on the gift to $13, with the result that the donor's effective cost is reduced to $63. While the current regime is a marked improvement from the donor's viewpoint, it is still more costly than a gift of cash. If the rule were amended to eliminate the capital gain on the donation, the donation would be equivalent to a gift of cash with a cost to the donor of $50.

In the case of short-term capital assets, the current regime seems to be more generous, reducing the cost to the donor to $38 and thus making a gift of securities more attractive than a gift of cash. If the capital gain were eliminated entirely, the cost would be reduced to $25. It is difficult, however, to believe that such short-term capital assets are commonly the subject of this provision. In the normal course, publicly traded securities held for a short term would be regarded as inventory[9] and would not be subject to this rule, which applies only to capital properties. Gifts of inventory still involve a full income inclusion of the accrued gain on the making of the gift.

The following table summarizes these results for long-term assets:

Donation	"Cost" to donor	Tax expenditure
	dollars	
Net proceeds	83	17
Securities (old regime)	75	25
Securities (current regime)	63	37
Securities (no capital gain)	50	50
Cash	50	50

8 For the purposes of simplicity, I have used the current capital gains inclusion rate of 50 percent and assumed a 50 percent combined federal-provincial tax rate.

9 Unless the holder had elected under subsection 39(4).

THE STATISTICS

For an assessment of the wisdom of the tax policy underlying paragraph 38(a.1), the most appropriate starting point is probably to examine the impact of the rule on federal-provincial finances since it was first introduced. The most recent available figures cover the period from 1997 to 2000.[10] During that period, gifts of publicly traded securities rose from $69.1 million in 1997 to $200.3 million in 2002, a cumulative growth rate of 190 percent,[11] while total charitable gifts rose from $4,316 million to $5,076 million, a cumulative growth rate of 18 percent. As a result, gifts of publicly traded securities rose from 1.6 percent of all charitable gifts in 1997 to 3.9 percent in 2000. On average during this period, 81.5 percent of donations of publicly traded securities were made to large and medium-sized charities.[12] The bulk of these donations went to educational institutions (42.9 percent), followed by welfare charities[13] (25.4 percent), health (13.2 percent), religion (12.1 percent), and benefits to the community[14] (6.0 percent). Public foundations received almost 60 percent of donations of publicly traded securities, although they received only 15 percent of overall charitable donations. The average value of donations of publicly traded securities to public foundations was $47,400.00; the average value of such gifts to charitable organizations was $43,300.00.

The Department of Finance summarizes the tax impact of the rule during the period from 1997 to 2000 as follows:

> As indicated in Table 7, if all donations of listed securities came about as a result of the 1997 budget measure, and if in the absence of the measure the securities would have been sold instead of donated, then the cost of the measure rose from $26 million in 1997 to $73 million in 2000. If, on the other hand, these donations—whether in cash or shares—would have been made in the absence of the measure, the total cost rose from $6 million to $15 million over the same period. Actual costs would be between these two ends of the spectrum.
>
> These figures do not include the cost to provincial governments, which have similar credits for charitable donations. On average, for every dollar of federal assistance, there would be almost $0.50 of provincial assistance. In 2000, for example, the combined federal-provincial cost, at the high end of the spectrum, would be about $105 million.

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10 Supra note 2. These statistics cover only gifts by individuals since no records are available for corporate donations of publicly traded securities.

11 Unfortunately, because there are no statistics on gifts of publicly traded securities before 1997, we are not in a position to evaluate to what extent this rule increased donations in 1997.

12 Defined on the basis of total receipts: $10 million and over—large; between $1 million and $10 million—medium.

13 Defined as organizations that provide assistance to economically disadvantaged people.

14 Defined to include charities such as community foundations and art galleries.

Table 7 Tax Expenditure Cost of the Half Inclusion Rate Measure

Component of cost	1997	1998	1999	2000	Total
			$ millions		
Reduction in tax on capital gains	6	6	13	15	40
Increased use of the charitable donations credit[a]	20	24	39	58	141
Total cost	26	30	52	73	181

[a] Assumes all donations of listed securities came about as a result of the 1997 budget measure.

It should be noted that, consistent with the standard methodology and presentation, only the cost directly attributable to the reduced inclusion of capital gains by the donor is shown separately in the annual tax expenditure tables (Part 1 of this publication). The total cost of the measure is the sum of that amount and the amount that represents the increased use of the charitable donations credit that resulted from new donations.[15]

Thus, the Department of Finance estimates that the combined federal-provincial cost of the rule for the four-year period between 1997 and 2000 was approximately $272 million, or roughly $68 million per year. This is, of course, a high-end projection of cost, which is premised on the assumption that none of these gifts would have been made if the new rule had not been introduced. If the gifts would have been made in any event, the estimate of the incremental federal-provincial cost falls to $60 million for the period, or $15 million per year. Since there are no separate records of gifts of publicly traded securities before 1997, no firm empirical data are available on the annual incremental cost on the introduction of this rule.

From 1997 to 2000, federal tax expenditures on charities rose from roughly $1,200 million to roughly $1,400 million. Thus, the combined federal-provincial tax expenditures in this area are estimated at roughly $1,800 million to $2,100 million, or an average of about $1,950 million per year. Therefore, the increase in combined tax expenditures attributable to this rule is between 0.8 percent and 3.5 percent.

THE POLICY RATIONALE FOR THE RULE

In my view, there are a number of policy considerations that favour the rule:

1. It is clear that the rule has increased the amount of donations to Canadian charities. The increase of 190 percent in gifts of publicly traded securities between 1997 and 2000 strongly suggests that those gifts would not have been made if the new rule had not been introduced. As discussed above, overall charitable donations over the period increased by only 18 percent.

15 Supra note 2, at 68.

Anecdotal evidence of charities receiving large gifts of publicly traded securities[16] also supports the position that such gifts were in large part facilitated by the introduction of the new rule.

2. In my view, most gifts that have benefited from this rule have been gifts of what I have termed "long-term assets." Accordingly, the amount of expenditure attributable to the "increased use of the charitable donations credit" estimated by the Department of Finance should be reduced to the present value of the tax that would have been realized on the ultimate disposition of those securities had they not been donated. Depending on the discount rate selected, the net present value of tax that would be realized on the death of a surviving spouse (possibly 20 or 30 years in the future) would likely be negligible. It is that present value that is the real tax expenditure, not the tax forgone on a current gift that would not have been made but for this rule.
3. Thus, I believe that the true tax cost of the rule is essentially only the reduction in tax on capital gains, estimated by the Department of Finance to be approximately $40 million (at the federal level) between 1997 and 2000. During most of that period, the inclusion rate for capital gains was 75 percent. Since the inclusion rate has now been reduced to 50 percent, a comparable annual cost today would likely be closer to $6 million to $7 million. Accordingly, I would argue that the annual increase in charitable tax expenditures is relatively small and quite likely not statistically significant.
4. I would go further and argue that the capital gain on donations of publicly traded securities should be entirely eliminated. Such a measure would result in an annual tax expenditure of $12 million to $14 million (on the basis of the assumptions set out in point 3 above). Again, this would be a minimal amount of the overall tax expenditure on charitable donations (approximately 1 percent of such expenditures in 2000). Moreover, the new measure would simply put donations of marketable securities[17] on exactly the same footing as cash donations in terms of the amount of tax expenditure (that is, 50 percent of the donation).
5. One of the Department of Finance's primary motivations for introducing the rule was that it would provide Canadian donors with a tax advantage similar to that enjoyed by donors in the United States, which has had a similar rule for some time. In the absence of the rule, Canadian charities were considered to be at a competitive disadvantage in relation to US charities. This concern was particularly significant with respect to donations to universities and medical and other research institutions. It has long been accepted that investments in such institutions are fundamental to Canada's international competitiveness and productivity. It is surely not coincidental that 56.1 percent of gifts of securities during the 1997-2000 period went to such institutions.

16 The Hospital for Sick Children Foundation, for one example.

17 In the case of long-term assets.

6. As I have noted previously, a disproportionate amount of donations of publicly traded securities was made to public foundations (almost 60 percent, as opposed to 15 percent of other donations). In my view, this is evidence that such gifts are being used to establish long-term charitable endowments; in many cases, these public foundations are likely companion institutions to operating charities, since that is the norm in the case of most large to medium-sized charities. The use of this tax expenditure to encourage the formation of endowments addresses the issue of stable long-term funding for our major charitable institutions and should ultimately limit their dependence upon public funds.
7. Charitable institutions that receive public funding have been hit very hard by government cutbacks over the course of the last decade. This has been particularly so for educational institutions, institutions providing forms of welfare assistance, and medical institutions. The experience between 1997 and 2000 suggests that these institutions tend to be the primary recipients of gifts of publicly traded securities (81.5 percent). There is a measure of equity in seeing such institutions receive a modest redress in the face of the substantial cuts that they have borne in the past.

In summary, I think that the rule respecting gifts of publicly traded securities provides significant competitive and structural advantages to Canadian charities, while compensating in some measure for the massive funding cuts that many of them have had to face in recent years. All this appears to be accomplished at what is, arguably at least, a minimal cost that does not increase Canadian tax expenditures in the charitable sector by any statistically significant amount. In light of the success of this program and the relatively small costs involved, I think that the Department of Finance should take the further step of eliminating completely the taxable capital gain on such donations.

APPENDIX

Donation of net proceeds	**Long-term asset**
	dollars
FMV (A)	133
Tax on capital gain on sale (B)	33
Tax credit to donor (C)	50
Net to charity (A – B)	100
Net cost to donor (A – C)	83
Net cost to fisc (C – B)	17
Donation of securities—old regime	
FMV (A)	100
Tax on capital gain on donation (B)	25
Tax credit to donor (C)	50
Net to charity (A)	100
Net cost to donor (A + B – C)	75
Net cost to fisc (C – B)	25
Donation of securities—current regime	
FMV (A)	100
Tax on capital gain on donation (B)	13
Tax credit to donor (C)	50
Net to charity (A)	100
Net cost to donor (A + B – C)	63
Net cost to fisc (C – B)	37
Donation of securities—no capital gain	
FMV (A)	100
Tax on capital gain on donation (B)	0
Tax credit to donor (C)	50
Net to charity (A)	100
Net cost to donor (A + B – C)	50
Net cost to fisc (C – B)	50
Donation of cash	
Amount (A)	100
Tax credit to donor (B)	50
Net to charity (A)	100
Net cost to donor (A – B)	50
Net cost to fisc (B)	50

Donation of net proceeds	**Short-term asset**
	dollars
FMV (A)	133
Donor's economic interest (B)	100
Tax on capital gain on sale (C)	33
Tax credit to donor (D)	50
Net to charity (A – C)	100
Net cost to donor (B – D)	50
Net cost to fisc (D)	50
Donation of securities—old regime	
FMV (A)	100
Donor's economic interest (B)	75
Tax on capital gain on donation (C)	25
Tax credit to donor (D)	50
Net to charity (A)	100
Net cost to donor (B + C – D)	50
Net cost to fisc (D)	50
Donation of securities—current regime	
FMV (A)	100
Donor's economic interest (B)	75
Tax on capital gain on donation (C)	13
Tax forgone on capital gain (D)	13
Tax credit to donor (E)	50
Net to charity (A)	100
Net cost to donor (B + C – E)	38
Net cost to fisc (D + E)	63
Donation of securities—no capital gain	
FMV (A)	100
Donor's economic interest (B)	75
Tax on capital gain on donation (C)	0
Tax forgone on capital gain (D)	25
Tax credit to donor (E)	50
Net to charity (A)	100
Net cost to donor (B + C – E)	25
Net cost to fisc (D + E)	75
Donation of cash	
Amount (A)	100
Tax credit to donor (B)	50
Net to charity (A)	100
Net cost to donor (A – B)	50
Net cost to fisc (B)	50