PRB 03-23E

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THE TAXATION OF CAPITAL GAINS ON CHARITABLE DONATIONS OF LISTED SECURITIES

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13 November 2003

PARLIAMENTARY RESEARCH BRANCH
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THE CURRENT TAX INCENTIVE

The 1997 federal budget reduced by one-half the inclusion rate, for tax purposes, for capital gains[(1)] arising from donations of eligible securities[(2)] by individuals or corporations to charities (other than private charitable foundations). The 2001 federal budget made permanent this tax incentive, which was originally scheduled to expire on 31 December 2001.

To give some sense of the tax advantage resulting from a donation of such securities, Table 1 (below) sets out the hypothetical situation of a resident of British Columbia[(3)] who made a donation, in 2002, of eligible securities to a public foundation. The fair market value of the donated securities was $200,000.

In example A of Table 1, it is assumed that the donated securities, originally acquired for $100,000, are now valued at $200,000 for a $100,000 capital gain. In example B, it is assumed that the donated securities were acquired for $0. The total tax reduction for the donor is the sum of the charitable tax credit and the tax incentive that reduces by one-half the inclusion rate for capital gains arising from gifts of listed securities.

(1) The rate was reduced from 50% of capital gains to be included in taxable income to 25% of capital gains.

(2) Eligible securities are shares, debt obligations and rights listed on a prescribed stock exchange, shares of the capital stock of mutual fund corporations, units of mutual fund trusts, interests in certain segregated fund trusts, and prescribed debt of, or guaranteed by, Canada or a province (Department of Finance, *The Budget Plan 2001*, December 2001, p. 222).

(3) There is no special significance in the choice of British Columbia. Marginal tax rates and charitable tax rates vary slightly by province/territory.

Table 1

Taxation Year 2002	Example A	Example B
Donation of listed securities	$200,000	$200,000
Capital gains realized on the donated securities	$100,000	$200,000(1)
Marginal income tax rate (total federal and provincial)(2)	43.7%	43.7%
Charitable tax credit rate (total federal and provincial)(3)	43.7%	43.7%
Capital gains tax reduction rate (½ x 50% x 43.7%)	10.9%	10.9%
Charitable tax credit	$87,400	$87,400
Capital gains tax reduction	$10,925	$21,850
Total tax advantage (reduction of tax payable)	$98,325	$109,250
Combined governments' share of donation(4)	49.2%	54.6%

(1) Assuming a zero cost base.
(2) Illustrative of a B.C. taxpayer in the highest federal and provincial tax brackets (respectively 29% and 14.7%). Source: *What are the income tax rates in Canada for 2002?* Canada Customs and Revenue Agency, http://www.cica-adrc.gc.ca.
(3) For simplicity, the lower credit rate that applies on the first $200 donated is ignored.
(4) Assuming that the donor would have donated the same amount in cash if not in securities.

The value of the charitable tax credit is obtained by applying the charitable tax credit rate (43.7%) to the total value of the gift ($200,000). The capital gains tax reduction is obtained by calculating one-half of the donor's capital gains tax rate (i.e., 50% of the donor's marginal tax rate of 43.7%) and applying this rate to the capital gains realized on the donated securities, respectively $100,000 and $200,000 in examples A and B. The total tax advantage to the donor (reduction of tax payable) corresponds to the portion of the donation of securities (valued at $200,000) that is ultimately assumed by the provincial and federal governments. In example A above, it is 49.2% of the market value of the gift of listed securities that is assumed by governments; in example B, this proportion is 54.6%.

THE FISCAL COST OF THE INCENTIVE

Government estimates and projections of the fiscal cost associated with the reduced inclusion rate for capital gains on donated listed securities are found in the annual Department of Finance publication entitled *Tax Expenditures and Evaluations*.

Table 2
Estimated Fiscal Cost of the Reduced Inclusion Rate for Capital Gains on Donated Listed Securities, 1997-2000
($ Millions)

Component of Cost	1997	1998	1999	2000
Reduced inclusion rate for capital gains arising from certain charitable donations(1)	6	6	13	15
Increased use of the charitable donation credit, assuming all donations came about as a result of the measure and that donors would not have otherwise donated in cash	20	24	39	58

(1) Includes donations of listed securities and, for 2000, ecologically sensitive lands. Excludes corporate donations, due to lack of data.

Source: Department of Finance, *Tax Expenditures and Evaluations: 2002*, Table 7, p. 68.

As shown in Table 2, the fiscal cost of this measure is estimated at $15 million for 2000. Moreover, since it is assumed that the introduction of the tax incentive may have led to more donations of listed securities than would otherwise have occurred, Table 2 also includes estimates of the fiscal cost that may have resulted from the use of the charitable tax credit – assuming that no donors of listed securities would have donated in any form (e.g., in cash) had this tax incentive not existed. (This assumption may not, however, be realistic, since it is possible that many donors would have donated to charities – although maybe less generously – even without additional incentives resulting from the 1997 federal budget measure.) The actual fiscal cost for 2000 is probably between $15 million and $73 million; the exact cost cannot be determined because data are unavailable on any incremental donations resulting from the measure.

These cost estimates do not include the cost to provincial/territorial governments, which offer similar credits for charitable donations. The Department of Finance has estimated that the combined federal-provincial/territorial cost would not have exceeded $105 million in 2000.[4]

(4) Department of Finance, *Tax Expenditures and Evaluations: 2002*, p. 68.

THE EFFECTIVENESS OF THE INCENTIVE

The 2002 edition of the Department of Finance's *Tax Expenditure and Evaluations* report(5) reviewed the effectiveness of the 1997 measure and found that:

- From 1997 to 2000, the value of gifts of publicly traded securities almost tripled, a significantly faster growth than that of other types of donations.
- While publicly traded securities made up only a small proportion of total donations to charities, their share of total donations more than doubled (from 1.6% to 3.9%) between 1997 and 2000.
- From 1997 to 2000, the number of donors of eligible securities rose from 500 to 2,400.
- Gifts of eligible securities benefited charities of different sizes, sectors, and charitable designation (although charities in the education sector and public foundations received proportionally more gifts of securities than might have been expected, based on their respective shares of total receipted donations).

Although these findings appear to confirm the tax incentive's effectiveness, the Department of Finance's report, as well as several commentators, have identified data limitations and other relevant factors that should be considered in assessing the success of this measure:

- Data on donations of securities were not collected prior to 1997. Therefore, it is impossible to assess whether gifts of securities increased as compared to previous years when the tax advantage was not in force.
- In addition to the one-half inclusion rate reduction, the strong economy and robust stock market performance from 1997 to 2000 may have substantially contributed to the reported rise in donations of securities during this period. However, the potential influence of these factors on donated securities was not taken into consideration because of data limitations.
- It was not possible to isolate the effect of other policy changes implemented during that period that were also intended to encourage charitable giving, such as changes to net income limits.
- The Department of Finance could not measure the extent to which individuals may have substituted gifts of securities for cash donations.(6)

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(5) *Ibid.*, p. 61.

(6) Donors may have substituted gifts of securities for cash donations without donating more in securities than they would have otherwise donated in cash. This, however, is equivalent to assuming that a tax incentive does not encourage people to donate more.

When the federal government introduced this tax measure in its 1997 budget, it indicated that the new provision would be terminated in five years if there was no evidence that it had effectively contributed to increased donations and that those additional donations were fairly distributed among charities.

Lisa Philipps, of Osgoode Hall Law School at York University, has argued that the Department of Finance report provides insufficient evidence for determining that both of these conditions for retaining the tax measure have been met. According to Professor Philipps, "[i]n fact, read carefully, the report raises more questions than it answers."(7) She suggested that the evidence presented in the report may have justified, at best, extending the provision for another five years to allow for a review over a more representative period.

In its evaluation of the tax measure's effectiveness, the Department of Finance showed that total donations rose by 10.1%, 4.1% and 2.1% in 1998, 1999 and 2000 respectively, whereas the growth in gifts of listed securities was much faster, at 20.6%, 62.9% and 47.6% in 1998, 1999 and 2000 respectively.(8) Professor Philipps claimed that the fact that gifts of securities grew faster than other types of donations during the evaluation period does not constitute conclusive evidence that the tax incentive contributed to an increase in donations of all kinds, as opposed to simply a shift in the form of donations. Professor Philipps presented yearly percentage increases in total donations from 1985 to 1997 (see the Appendix to this paper), and concluded that overall growth in donations has not changed significantly since the 1997 introduction of the tax measure for gifts of listed securities; in fact, rates of growth in 1999 and 2000 may be historically low in light of the strong economic conditions that prevailed in those years. Professor Philipps suggested that the "rapid growth in donations of securities since 1997 represents merely a shift in the form of donations rather than a trend toward donating more."(9)

Another limitation identified by the Department of Finance is the inability to isolate the effects of other charitable tax incentives on the rise in donations. Professor Philipps noted that "[m]ost important, the income ceiling that limits how much a taxpayer can claim in respect of the charitable donations tax credit in a particular year was raised from 20% to 50% of

(7) Lisa Philipps, "Thinking Critically About the Taxation of Capital Gains on Donated Public Securities (or Looking Paragraph 38(a.1) in the Mouth)," *Canadian Tax Journal*, 2003, vol. 51, no. 2, p. 914.

(8) Department of Finance, *Tax Expenditures and Evaluations: 2002*, p. 64.

(9) Philipps (2003), p. 921.

net income in 1996, and then to 75% of net income in 1997,"[10] the year in which the tax measure for gifts of listed securities was introduced. Because the data used by the Department of Finance were obtained from individual income tax returns, the department's analysis included only donations that were actually claimed in any particular year (donations may be carried forward if the donor has insufficient taxable income). Certainly, raising the income ceiling may encourage donors to give more; but it should also be noted that in the years the ceiling was raised (1996 and 1997), donors who would otherwise have had to roll over part of their donations could now claim a larger portion of the gifts. This would have inflated the reported donations for those particular years, even if total donations (the sum of the portion claimed and the portion that is rolled over) did not actually increase.

Moreover, the 1997 federal budget called for a "fair distribution" of the new donations of listed securities among charities as a second condition for evaluating the effectiveness of the measure. The Department of Finance report mentioned that although gifts benefited charities of different sizes, sectors and designation, it was larger charities, charities in the education sector and public foundations that benefited proportionately more. Professor Philipps argued that the distributive biases noted in the report are "quite extreme" and pointed to the need for the federal government to define better what constitutes a "fair" distribution of these donations. For example, the distribution of gifts among provinces or regions was not taken into consideration.[11]

Professor Philipps suggested other kinds of information that could have been reviewed by the Department of Finance to improve the quality of the analysis. In particular, because there is a relatively small number of donors of listed securities, it would have been possible to conduct qualitative surveys or focus-group sessions with donors and charities. Such feedback would have helped to assess what effectively accounted for donors' change in behaviour (i.e., donating more in securities), and whether the numbers reported represent a net increase in charitable gifts or merely a substitution of securities for cash donations.[12] The reasons for, and the implications of, the disproportionate distribution of donations among charities of different sizes, sectors and designation were not discussed in the report. According

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(10) *Ibid*.

(11) *Ibid*., pp. 922-923.

(12) *Ibid*., p. 922.

to Professor Philipps, this omission should be dealt with and also explored further by the federal government in relation to its stated objective that gifts of securities be "fairly" distributed among charities(13) – particularly if (as stated in the 2001 federal budget) an expansion to the current 50% capital gains tax exemption may be considered.(14)

BROADENING THE TAX INCENTIVE TO ALLOW A COMPLETE CAPITAL GAINS TAX EXEMPTION: PROS AND CONS

The 2001 and 2002 pre-budget consultation reports of the House of Commons Standing Committee on Finance recommended broadening the current 50% reduction of capital gains tax on gifts of listed securities to allow a complete exemption. The United States already allows a complete exemption from capital gains tax on such gifts, while the Government of the United Kingdom recently introduced a similar exemption.

Below is a summary of arguments for and against allowing a complete exemption from capital gains tax on donations of listed securities in Canada.

A. Arguments in Favour

- The supporters of this proposal contend that it would induce substantial new donations to charities at a relatively modest cost in forgone tax revenues to federal and provincial/territorial governments. Their view is that the monetary benefits to society from a complete exemption would likely outweigh its fiscal cost.

- Reductions in provincial/territorial and federal marginal tax rates and in the capital gains inclusion rate since 1997 resulted in a lower fiscal cost of the measure for both levels of government. A complete exemption from capital gains tax on gifts of listed securities would bring the fiscal cost of the measure to just under its 1997 level.(15)

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(13) *Ibid.*, p. 923.

(14) The government mentioned, in the 2001 budget, that it is satisfied with the tax measure's contribution to supporting the work of charities and that it "intends to continue to work with the charitable sector to determine whether there is an appropriate and cost-effective basis for broadening this measure beyond its current application" (Department of Finance, *The Budget Plan 2001*, December 2001, p. 222).

(15) For example, in 1997, the highest marginal tax rate for a B.C. resident was about 50% and the inclusion rate for capital gains was 75%. Therefore, in 1997, up to approximately 69% of the cost of a gift of securities was assumed by governments. In 2002, up to 54.6% was assumed by governments; and with a complete capital gains exemption, up to 65.5% would be assumed by governments.

- The Canadian charitable sector relies heavily on private donations to fund its operations. Supporters contend that a complete exemption would increase private funding to charities on a tax-effective basis. For them, the fact that a disproportionate amount of the value of gifts of securities went to public foundations is not a concern, since such gifts are being used to establish long-term charitable endowments. According to one supporter, "[t]he use of this tax expenditure to encourage the formation of endowments addresses the issue of stable long-term funding of our major charitable institutions."(16)

B. Arguments Against

- One commentator argued that this tax measure has a regressive effect on the distribution of the tax burden, especially since capital gains are received disproportionately by higher-income individuals.(17) Also, the tax measure stimulates new tax planning strategies. The favourable tax treatment for one type of donation over other forms is inequitable to donors who do not have appreciated securities to donate. For some observers, however, the 50% exemption on capital gains achieves a balance between equity considerations and additional incentives to give. Others have argued that as long as the gifts benefit the community as a whole, this regressive effect should not be of undue concern.(18)

- There could be a strong substitution effect at work, i.e., donors of appreciated securities might have donated the same amount in cash or in non-appreciated securities, had it not been for the special tax incentive. Consequently, an increased tax incentive might not encourage people to donate more.

- Another commentator has argued that while this tax incentive may be "more cost-effective than other kinds of tax assistance for charitable donations, its distributional impact is arbitrary and inequitable, with the magnitude of the tax benefit increasing both with the amount of unrealized appreciation that happens to have accrued on the specific securities and with the donor's marginal rate of tax."(19)

- Commentators have also suggested that incentives designed to promote large donations of capital property contribute to a transfer of part of the decision-making power over what services are provided by the charitable sector, from elected governments and the community as a whole to a minority of affluent donors.(20)

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(16) William I. Innes, "The Case for Tax Incentives on Gifts of Publicly Traded Securities," *Canadian Tax Journal*, 2003, vol. 51, no. 2, p. 911.

(17) Philipps (2003), p. 914.

(18) Robert D. Brown and Yvan Guillemette, "Tax Treatment of Charitable Donations: How Much is Enough?" Backgrounder no. 70, C. D. Howe Institute, February 2003, p. 6.

(19) David G. Duff, "Special Federal Tax Assistance for Charitable Donations of Publicly Traded Securities: A Tax Expenditure Analysis," *Canadian Tax Journal*, 2003, vol. 51, no. 2, p. 932.

(20) In particular, this argument has been made by David Duff and Lisa Philipps.

- Currently, this tax incentive is not available for donations of listed securities to private foundations. As noted by some commentators, if this differential treatment were to continue in any extension of the current tax advantage, the difference in the tax treatment of gifts to private foundations relative to that of gifts to public charities would widen.[21]

There is no simple answer as to whether Canada should introduce a more generous capital gains tax reduction, or even an exemption, for gifts of listed securities. As some commentators have observed, "different individuals will come to different conclusions depending on their assessment of how well charities in general and, perhaps more directly, the particular charities that they are interested in, deliver value to the public."[22] Finally, the desirability of introducing a more generous tax treatment of charitable donations greatly depends on individual beliefs about the role that both governments and individual philanthropists should play in the funding of charities, and the resulting implications for social services provided by charities and the public sector.

(21) Brown and Guillemette (2003), p. 6.

(22) *Ibid*., p. 8.

APPENDIX

Percentage Increase in the Value of Charitable Donations Over the Previous Year, 1985-1997

Year	% Increase
1985	9.1
1986	9.0
1987	12.3
1988	8.1
1989	9.3
1990	6.6
1991	3.8
1992	2.9
1993	2.6
1994	0.3
1995	4.0
1996	12.9
1997	7.7

Source: Philipps (2003), p. 921.