

Enhancing the tax benefits of charitable giving

Donation of Flow-Through Shares and Lifetime Giving



Charitable giving is an integral part of the financial and estate planning strategy many individuals develop. While the tax benefits associated with charitable donations are generally secondary reasons for giving, it is important to recognize how the nature of the donated asset and the timing of the donation can maximize the tax savings related to these gifts.

Donation of flow-through shares

Since May 2, 2006, when the federal government enhanced the tax benefits with respect to the donation of publicly listed securities to charities, gifts of this nature have become more common. The enhanced tax benefits come in the form of the elimination of income tax on the capital gains realized on the donation of the securities to public charities¹ after May 1, 2006, and to private foundations after March 18, 2007. The tax benefit can be further enhanced when the gift is in the form of flow-through shares of publicly listed entities.

Investments in flow-through units or shares

Flow-through units or shares are generally resource-based investments that allow the issuing entity to renounce its exploration expenditures in favour of the investor. As a result, the investor is entitled to claim tax deductions for its allocated share of renounced

expenditures such as Canadian exploration expenditures (CEE) and Canadian development expenditures (CDE).

The investor's tax cost base of their investment in the flow-through units are reduced by the amount of the renounced expenditures allocated to the investor. Typically, the magnitude of the expenditures allocated to the units or shares equals the initial costs of the investment; thus, the tax cost base of the shares is nominal after the exploration activities have been completed. The investor then converts his or her interest in the flow-through entity on a tax-deferred basis into a publicly listed security that is listed on a designated stock exchange. The publicly listed security could then be sold in the open market and/or donated to a Canadian registered charity or other qualified donee.

¹. Public charities are generally registered charities other than those designated as private foundations.

Donation of flow-through shares

An individual donor is entitled to a donation tax credit equal to the fair market value of the publicly listed securities when the securities are donated to a qualified donee. The tax benefits that are associated with gifts of publicly listed securities, coupled with the tax relief associated with the renounced expenditures allocated to the investor, significantly reduces the after-tax cost of making a charitable donation of flow-through share investments.

Example A illustrates the enhanced tax benefits to an individual of donating “flow-through shares,” assuming an initial investment of \$100,000, renounced expenditures of \$100,000 allocated to the individual, a donation of publicly listed securities having a fair market value of \$100,000, and a tax cost base of \$0 for the flow-through shares at the time of donation. The example compares the tax benefits and cost of the donation of the flow-through shares to a similar donation of publicly listed securities that are not flow-through shares. The example assumes that the donor is a Canadian individual who is subject to a combined federal and provincial marginal tax rate of 45%.

Example A: Publicly listed security donation (non flow-through share versus flow-through share) by an individual donor (after May 1, 2006)

| | Publicly Listed Non Flow-Through Shares | Publicly Listed Flow-Through Shares |
|--|--|--|
| Initial cost of investment | \$100,000 | \$100,000 |
| Less: CEE and CDE | N/A | (100,000) |
| Tax cost of investment | \$100,000 | \$ NIL |
| Proceeds of disposition/donation | \$100,000 | \$100,000 |
| Less: tax cost | \$100,000 | \$ NIL |
| Capital Gain | \$ NIL | \$100,000 |
| Tax on capital gain | \$ NIL | \$ NIL |
| Initial cost of investment | \$100,000 | \$100,000 |
| Tax (benefit) of CEE and CDE to investor | N/A | (45,000) |
| Tax on capital gain | (NIL) | (NIL) |
| Tax (benefit) of donation tax credit | (45,000) | (45,000) |
| After-tax cost of donation | \$55,000 | \$10,000 |

Additional considerations

Although the donation of flow-through shares can be a tax-efficient method of charitable giving, the following potential issues should be considered by the donor and/or the charity:

- The fair market value of the security being donated must be determinable at the time the gift is made. The valuation issue affects the amount the charity will report on the donation tax receipt, and therefore the associated tax benefits for the donor.
- The donor should consider whether any tax implications could impair his or her access to the tax benefits related to resource deductions and related to the full fair market value of the donated property, including the incidence of alternative minimum tax.
- The donor must gift the qualifying shares to the charity. If the donor makes a gift to the charity of the proceeds on the sale of the shares, or grant the rights to those proceeds, he or she will not receive capital gains tax relief.

- As part of the transaction, the donated shares must be registered in the name of the charity, so that the charity can decide independently whether to retain or dispose of the shares.
- The charity should consider if there are any restrictions (e.g., holding periods), market risks or unusually high expenses related to the disposition of the donated property, and whether these outweigh the benefits of accepting the gift.

Lifetime giving

Consistent with humourist Jim Hightower's observation "I never saw a hearse pulling a U-Haul," individuals generally make their most significant charitable donations through their wills. While these gifts are often extremely generous, they can prove to be ineffective for tax purposes.

Annual net income limitation

In general, an individual's annual donation claim is limited to 75% of net income.² However, the limit is increased to 100% of net income in the year of death and the year immediately preceding death.

Gifts at death

Charitable donations made through a will are deemed to be made in the year of death and can therefore be claimed in the individual's final tax return. Any excess donations can be carried back one year, subject to the 100% of net income limitation.

Example B illustrates that an individual may be better off making a donation in annual instalments during his or her lifetime rather than making a significant donation upon death. The example compares the tax benefits associated with a will that makes a \$600,000 cash donation upon death to a lifetime giving plan of \$600,000 in cash spread over four years. It is assumed that the individual dies in 2012, his or her annual net income is \$200,000 from 2009 to 2012, no other charitable donations were made during that period, and the individual's combined federal and provincial marginal tax rate is 45%.

2. Generally, net income includes total income received from all sources, such as employment, pension, interest, dividends, capital gains, and business, less certain items such as Registered Retirement Savings Plan (RRSP) deductions, carrying charges, and employment expenses.

Example B: Lifetime giving plan versus bequest at death by an individual donor

Total tax liability associated with the bequest:

| | 2009 | 2010 | 2011 | 2012 | Total |
|-------------------------------|---------------------|-----------------|------------|------------|----------------------|
| Net Income | \$200,000 | \$200,000 | \$200,000 | \$200,000 | \$800,000 |
| Maximum donation ³ | 0 | 0 | 166,666 | 166,667 | 333,333 ⁴ |
| Income tax | 75,000 ⁵ | 75,000 | 75,000 | 75,000 | 300,000 |
| Donation tax credit | 0 | 0 | (75,000) | (75,000) | (150,000) |
| Net income tax | \$75,000 | \$75,000 | \$0 | \$0 | \$150,000 |

Total tax liability associated with the lifetime giving plan:

| | 2009 | 2010 | 2011 | 2012 | Total |
|-----------------------|---------------------|---------------------|---------------------|---------------------|-----------------|
| Net Income | \$200,000 | \$200,000 | \$200,000 | \$200,000 | \$800,000 |
| Maximum donation | 150,000 | 150,000 | 150,000 | 150,000 | 600,000 |
| Income tax | 75,000 ³ | 75,000 ³ | 75,000 ³ | 75,000 ³ | 300,000 |
| Donation tax credit | (67,500) | (67,500) | (67,500) | (67,500) | (270,000) |
| Net income tax | \$7,500 | \$7,500 | \$7,500 | \$7,500 | \$30,000 |

Lifetime giving plan and bequest compared:

| | Lifetime giving | Bequest |
|-------------------------|-----------------|------------------|
| Net income | \$800,000 | \$800,000 |
| Net income tax | (30,000) | (150,000) |
| After-tax income | 770,000 | 650,000 |
| Unused donation | \$0 | \$266,667 |

The enhanced tax benefit provided on the donation of publicly listed securities to charities, as discussed previously, has generally made the lifetime giving plan more tax-efficient than satisfying charitable bequests in a will with the donation of marketable securities.

Summary

This article has highlighted two potential strategies for enhancing tax benefits when contemplating a charitable gift plan:

- donation of flow-through shares; and
- giving during one's lifetime.

For a further discussion of donation strategies and income tax incentives associated with charitable giving, please refer to our publication *Reaching Out — Charitable Giving Guide for Donors*, which is available on our website (www.pwc.com/ca) or from a local PricewaterhouseCoopers contact.

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3. As discussed previously, the annual donation claim limit is 100% of net income in the year of death. Excess donations made in the year of death can be carried back to 2011 and applied against 100% of net income. However, tax credits cannot be carried back to 2009 and 2010.

4. Only \$333,333 of the \$600,000 donation is required to eliminate the tax liabilities for 2010 and 2011. As a result, the tax benefit on unused donations of \$266,667 (\$600,000 - \$333,333) is lost.

5. The \$75,000 tax liability is less than 45% of \$200,000 because the assumed 45% top marginal rate applies only to taxable income above a certain level (\$126,264 in 2009).