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I N D E P E N D E N T ▪ R E A S O N E D ▪ R E L E V A N T

Strengthening our Charities During a Period of Economic Crisis

A Tax-Effective Stimulus for our Not-for-Profit Sector

Proposals Made to the C.D. Howe Institute Conference

Strengthening Canada's Charities

Donald K. Johnson C.M.

We face unprecedented challenges stemming from the financial, credit and economic crises which have struck the United States. Their problems have now spread to Canada and the rest of the world. This has, in turn, created fiscal challenges for Canadian charities as well as governments. Given the gravity of these challenges, I propose three specific measures that the government should include in the budget on January 27th, 2009. These measures will stimulate much needed greater private sector funding for Canada's not-for-profit sector. To convince the government to do so, our charities must show the government that these proposals are not only good public policy, but also good politics.

Our Success to Date

Prior to 1997, charities received virtually no gifts of stock because donors had to pay a capital gains tax on such gifts. The government's decision to eliminate the capital gains tax on gifts of listed securities in its May 2006 budget has been an enormous success. It has unlocked a huge amount of private wealth for public good. Two years ago, I compiled a list of publicly announced stock donations since 1997, when the capital gains tax was reduced by 50%. Including future pledges, it totalled over $3 billion! Since the 2006 budget measure, there has been a further dramatic increase in gifts and pledges of securities.

Eliminating the capital gains tax would not have happened in a minority government without the unanimous support of all four parties – the Conservatives, the Liberals, the NDP and the Bloc Quebecois. It was one of the few public policy issues upon which all four parties agreed. The benefits are widely recognized, not only in Ottawa, but also across Canada. Our not-for-profit sector is grateful to the MPs of all four Parties for their enlightened support.

Fiscal Challenges Facing our Charities and Governments

Although our not-for-profit organizations have benefitted enormously up to now, all this has changed completely since the collapse of the stock market during the past few months. The credit and financial crisis have raised significant challenges for the charitable sector. Many donors have been reducing the level of their charitable giving as a result of losses in their stock portfolios. It makes no sense to give shares when there is no capital appreciation. To take one example, the widely reported demise of the BCE "going private" transaction, will result in charities not receiving tens of millions of dollars of anticipated donations from BCE shareholders had the transaction proceeded. Shareholders would have realized substantial capital gains.

Compounding the problem for charities is the decline in the value of endowment funds that were heavily invested in the stock market. This has resulted in a reduction in the annual disbursements by endowment funds – disbursements which provide crucial support for professors, medical professionals, researchers and students. The University of Toronto recently announced that there will be no disbursements next year from its endowment funds. Previously, the University had planned to distribute $62 million to support research, student aid and faculty posts. And many community foundations across Canada have had to reduce, or in some cases, suspend, their annual grants to thousands of charitable organizations.

We are experiencing the biggest credit and financial crisis since the Great Depression. No one is quite sure when and where it will end. Our federal government is moving into a fiscal deficit and is also under pressure to introduce significant economic stimulus in the upcoming budget. This will make it difficult to provide the same level of funding, let alone increase funding, for healthcare, education, social services and the arts. Our not-for-profit sector employs 2.1 million Canadians and provides essential services that benefit virtually all Canadians.

We Must Act Now to Address these Fiscal Challenges

There is a saying "Crises Create Opportunities." Now is the ideal time for Canada's not-for-profit sector to build on its success and to present new recommendations to the government which would encourage additional private sector funding on a basis that is tax effective for both the government and the donor.

I propose three new measures to respond to this need. In reaching my conclusions, during the past few weeks, I have consulted with certain Canadian and U.S. charities, fundraisers, philanthropists, and tax experts*.

MY PROPOSALS ARE AS FOLLOWS:

1. Exempt gifts of private company shares from capital gains taxes;
2. Exempt gifts of real estate from capital gains taxes;
3. Level the playing field between "arms-length" and "non-arms length" employees who exercise stock options and give the shares to a charity within 30 days.

These proposals are not mutually exclusive. They, accordingly, can be addressed simultaneously.

1. Exempt Gifts of Private Company Shares from Capital Gains Taxes

Currently in Canada, while gifts of publicly listed securities are exempt from capital gains taxes, gifts of private company shares are not. However, gifts of private company shares are exempt from capital gains tax in the United States. There is no reason why such donations in Canada should not also be exempt from capital gains taxes. Our not-for-profit organizations are competing with the U.S. for the best and the brightest talent, and we should level the fundraising playing field for Canadian charities.

The total market value of private company shares is equal to or greater than the market value of all Canadian companies listed on the TSX. The Business Development Bank of Canada published a study in February 2006, stating that Canadian family firms have annual sales of $1.3 trillion. The same study noted that three quarters of these firms would be engaging in succession planning over the next ten to twelve years. Based upon this annual sales figure, the potential market value of these companies is estimated to be around $1 trillion, compared to approximately $900 billion for all companies listed on the TSX. This figure assumes the typical private company would have a market value of one times annual sales. And the majority of these companies would have a very low tax cost base, relative to their current market value.

There are hundreds of thousands of small business that constitute almost half of Canada's gross domestic product and account for 60% of all private sector employment. 105,000 small and medium size businesses are members of the Canadian Federation of Independent Business (CFIB). From a political perspective, it is relevant that a significant portion of these private companies are likely located in smaller communities across Canada. Charities in these smaller communities would logically benefit from a significant number of large donations of these assets.

On the other hand, the primary beneficiaries of gifts of publicly listed securities have been charities located in larger cities across Canada.

While, in principle, donations of private company shares should also be eligible for the same tax treatment as publicly listed shares, the main concern which needs to be addressed is the potential for valuation abuse. On the one hand, we could capitalize on the U.S. experience and simply replicate their regulations for gifts of private company shares. Alternatively, we could create a Canadian solution which is consistent with Canadian rules that are already in place. Under the Canadian solution, the charity would be required to monetize the gift of private company shares within 5 years of their receipt. The charity would not issue a tax receipt to the donor until the shares had been monetized and the charity received the cash consideration. This process has the benefit of being simple, transparent, addresses any concern about any valuation abuse or self-dealing and treats donors of publicly listed securities and private company shares equitably.

2. Exempt Gifts of Real Estate from Capital Gains Tax

Other than gifts of ecologically sensitive land, gifts of real estate in Canada are not exempt from capital gains taxes, whereas they are in the United States.

Real estate is the most widely held asset in Canada, estimated to represent more than 40% of personal wealth. In looking at potential donations of real estate, however, principal residences should be excluded because sales of these residences are already exempt from capital gains taxes in Canada. To demonstrate the potential of such gifts in Canada, an illustrative example is the experience of the University of Florida. The University of Florida receives gifts of $170 to $220 million per annum. $30 to $50 million of this amount is from gifts of real estate! Another example of the potential benefits to Canadian not-for-profit organizations is a recent gift of real estate by a prominent Canadian philanthropist to Columbia University in New York. When she passed away last year, she made a multimillion dollar gift of Florida real estate to Columbia University. Her gift was exempt from capital gains tax. Such a gift could not have been made in Canada under the current tax regime, because it would trigger a capital gains tax.

As with gifts of private company shares, the Government of Canada could choose to replicate the U.S. regulations on gifts of real estate. However, Canadian charities would need to establish in-house resources to deal with real estate gifts, or, alternatively, outsource this expertise to other organizations. Receiving, managing, and monetizing gifts of real estate can be very complex and requires considerable expertise.

As with gifts of private company shares, there is also an opportunity for a Canadian solution. Under this scenario, the government could amend the Income Tax Act so that the donor assumes responsibility for selling the real estate on behalf of the charity. The cash proceeds from the sale of the real estate would need to be transferred to the charity within 30 days of the closing of the transaction. The charity would issue a charitable donation tax receipt at the time it receives the cash proceeds.

3. Level Playing Field on Shares Acquired by Exercise of Options and Donated to a Charity

Family members who are officers and/or directors of a public company, and collectively control over 50% of the votes, are classified as "non-arms-length" employees. When "non-arms-length" employees exercise their stock options, the stock option benefit (the difference between the exercise price and the market price) is taxed like ordinary income. This tax treatment for "non-arms length" employees applies whether or not the shares purchased by exercising the options are subsequently donated to a charity.

For all other publicly listed companies, however, "arms-length" directors and/or officers who exercise options, have their option benefit taxed at 50% of the normal income tax rate, effectively like a capital gain. Furthermore, if they exercise their options and donate the shares to a charity within 30 days, they are completely exempt from any tax on the option benefit. They also receive a charitable donation tax receipt for the full market value of the gift.

I strongly recommend that the government implement immediately one minor change in the Income Tax Act. Non-arms length employees who exercise stock options and donate the shares to a charity within 30 days should have the same tax treatment as arms-length employees. Removal of this barrier to charitable giving would result in significant increases in donations by directors and officers who are members of families that control public companies.

The need to create equality for the tax treatment of options exercised and the shares given to a charity is not inconsequential for charitable giving. The total market cap of companies in which families control over 50% of the voting shares is over $130 billion, or 15% of the total market cap of companies listed on the TSX.

Conclusion

It took 12 years before convincing the Government to eliminate completely the capital gains tax on gifts of listed securities in its 2006 budget. Given today's credit and financial crisis, charities can't wait for 12 years for the government to make a decision on these three proposals!

The upcoming budget presents a unique opportunity for the government to stimulate private sector funding for hospitals, universities, social service agencies, and the arts across Canada. The current financial crisis and stock market meltdown have placed Canada's charities in a very difficult fiscal situation. This is one public policy issue upon which all parties should agree. The time to act is now!

Donald K. Johnson, C.M. (abridged CV on attached Appendix A)

Appendix A

Donald K. Johnson, C.M.
Senior Advisor, BMO Capital Markets

Former Vice-Chairman, BMO Nesbitt Burns Inc.
Former President, Burns Fry Limited

NOT-FOR-PROFIT ORGANIZATIONS

Director, Toronto General & Western Hospital Foundation
Chair, $15 million Vision Campaign for Toronto Western Hospital
Member, Advisory Board, Richard Ivey School of Business, University of Western Ontario
Chairman Emeritus and Director, Business for the Arts
Director, Toronto Foundation for Student Success
Member, 2000 – 2008 Major Individual Giving Cabinet, United Way of Greater Toronto

PREVIOUS NOT-FOR-PROFIT ORGANIZATIONS

Former Director, National Ballet of Canada
Former Chair, $12 million "Bold Steps" Capital Campaign for the National Ballet
Former Chair, Eye Research Institute of Canada
Former Director, Bishop Strachan School Foundation

There is nothing more important than for all of us to give back to our communities. As Winston Churchill once said, "You make a living by what you get. You make a life by what you give"!