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Tax Treatment of Charitable Donations:

How Much is Enough?

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The Backgrounder in Brief

Tax support for the charitable sector in Canada has decreased in recent years with reductions in income tax rates. The authors discuss the present level of tax support and evaluate the most prominent suggestions for expanding it. Special emphasis is placed on the suggestion of fully exempting from tax the capital gains realized on donations of listed securities.

About the Authors

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The charitable sector in Canada is a study in diversity and, to some extent, in contradictions. Leaving aside large quasi-governmental institutions, such as hospitals and universities, it consists of numerous private, fiercely independent organizations, each responsible to its own members and for raising its own revenues. The charitable sector also receives substantial public support through the tax system, with minimal accountability.

Canada's 80,000 registered charities have $100 billion in annual revenue and more than that in net assets. The total charitable sector in Canada is about equal in size to the economy of British Columbia.

The biggest supporters of Canada's charities are governments — though the bulk of government transfers go to hospitals, universities and other quasi-governmental institutions, with only very modest grants, usually to specific projects, for other charities, most of which rely on donations. The sector that gets the largest share of private donations is religion.

Some of the other charities are major organizations concerned with welfare, research, the arts, education and policy. Many are small — about half report annual revenue of less than $50,000.

Support for charities is broad: 91 percent of Canadians over 15 say that they give to charities. But the average support is modest — Canada Customs and Revenue Agency reports that the average donations on Canadian tax returns in 2000 was $259. The total value of gifts reported by individuals was $5.4 billion and is growing. While a higher proportion of Canadians give to charities, Americans give more on average than Canadians.

The largest share of gifts from individuals comes from a relatively small group: the top one-quarter of donors gives 82 percent of all gifts.

In addition to donations of money, Canadians also give generously of their time. Almost eight million Canadians donate over a billion person-hours annually which, at prevailing wage rates, would have a notional value of over $15 billion.

Source: Canadian Centre for Philanthropy, CCRA, Statistics Canada.

Supporting Charities — How Much is Enough?

Charities provide enormous benefits to Canadians: they feed the hungry, care for the poor, support the sick, counsel the troubled, extend our vision: in many ways they are the glue that holds our society together, giving us a real sense of community and mutual support. But the question raised by this paper is not about the good that they do, rather it is about the support they receive from the tax system: should they get more or less — and how?

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Present Tax Support

Charitable organizations are themselves exempt from income and some other taxes, though the tax system gives them its most significant benefit by granting tax reductions to private donors. Until 1988, Canadians taxpayers were generally able to deduct charitable donations from their income, thereby obtaining a tax benefit equal to their marginal tax rate for these gifts. But this was replaced by a tax credit system whereby donors get a percentage of their donations as a credit that reduces taxes otherwise payable (any excess credit is non-refundable), with this credit being unrelated to their income level. Individuals giving donations to registered charities are now entitled to a federal tax credit[1] of 16 percent on the first $200 of the gift and 29 percent on the remainder. Additional tax credits are available in calculating provincial income taxes. Although the rates of both tax and credit vary somewhat from province to province, the combined federal-provincial tax credit on gifts over $200 is a little over 46 percent of the donated amount in Ontario: this is relatively close to the national average and will be used for simplicity in all combined federal-provincial figures used in this *Backgrounder*.

The preset tax-credit system[2] is substantially more favourable than the previous deduction system for annual gifts over $200 for low- and middle-income taxpayers. For example, individuals reporting $30,000 in income currently have a 16-percent marginal federal tax rate. A gift of $1,000 to a charity would reduce their federal tax bill by $160 under the deduction system, significantly less than the $264 reduction now received as a tax credit. For taxpayers in the highest tax bracket, with taxable incomes of $103,000 or above, the current tax credit has essentially the same result as a deduction.

The existing incentive seems to have been well-received by taxpayers: donations of appreciated securities tripled in value from 1997 to 2000.

The tax-credit system does not apply to corporations, which receive an income deduction — worth up to 43 percent (the top combined federal and provincial corporate rate) for their donations. Foundations also contribute relatively modest amounts to charities.

The cost of the personal tax credit for donations, in terms of foregone federal and provincial revenue, is about $2 billion annually;[3] the implied federal revenue reduction is shown in Table 1. This tax recognition is given with only moderate accountability: not all charities make their full financial statements public and the main effective supervision of charities rests with the relatively small staff[4] of the Charities Directorate of the Canada Customs and Revenue Agency.

Instead of contributing money directly, corporations and individuals may also give capital property to charities. Within that gift class, gifts of listed securities,[5] which have appreciated in value, have become much more popular in recent years,

1 Through non-refundable tax credits (i.e., the credit reduces federal tax otherwise payable — determined by applying the applicable tax rates to taxable income).

2 Adopted in 1988 to replace the previous system where individuals could claim a deduction in computing taxable income for their donations.

3 The federal revenue cost related to the corporate deduction of donations is over $200 million a year.

4 The Charities Directorate has only 15 dedicated field auditors to check Canada's 80,000 charities.

5 Shares of public companies listed on a recognized stock exchange.

Table 1: *Federal Tax Expenditures Estimates*

	Year	Personal Income Tax Expenditures
		($M)
Charitable Donations Credit[a]	1996	1,120
	1997	1,180
	1998	1,300
	1999	1,350
	2000	1,350
Half-Rate Taxation of Gifts of Securities[b]	1997	6–26
	1998	6–30
	1999	13–52
	2000	15–73

a Expenditures projected for 2001 to 2004 are, respectively, $1,335, $1,360, $1,385 and $1,410 million.

b Minimum tax expenditures for 2001 to 2004 are projected at $12 million a year.

Source: Department of Finance, *Tax Expenditures and Evaluations*, 2001 and 2002.

helped by even more generous tax treatment — the cost of this incentive is also noted in Table 1.

Under previous tax rules, an individual who donated listed securities to a charity was deemed to have disposed of the assets at fair market value, received a tax credit based on that value, but was taxed on the realized gain. However, under changes[6] made in 1997, taxes on donated securities are only payable on one half of the otherwise taxable gain. Since 2000, when the inclusion rate for capital gains generally was reduced to 50 percent, only half of that, or 25 percent of the total gain, is subject to tax.[7]

The range of tax expenditures shown for the reduced capital-gains rate illustrates the difficulty of estimating the revenue effects of these measures: the lower number, as is typical of tax expenditure calculations, shows the revenue loss on the assumption that in the absence of the half-capital-gain inclusion rule, the donation would have been made anyway. The higher number shows the cost on the assumption that in the absence of the measure, the gift would not have been made at all and hence the entire tax loss from the donation should be counted.

The existing incentive certainly appears to have been well received by taxpayers: donations of appreciated securities tripled in value from 1997 ($69 million or 1.6 percent of all donations) to 2000 ($200 million or 3.9 percent of donations) and, on the basis of the anecdotal evidence, have increased since. The donations of appreciated securities have been fairly widely dispersed among charities, although medium- and larger-sized charities — those with over $1 million in revenue in 1997 — received 80 percent of the gifts. Educational institutions, welfare organizations and health services were, in descending order, the largest recipients of such gifts. But only 2,400 donors made the entire $200 million of securities donations in 2000.

Table 2 shows the net cost of a gift of $100 worth of securities with a zero-cost base under the old and new rules and compares it with the net cost of a gift in cash. Using an example of a security with a zero-adjusted cost base is certainly far from typical, though it does highlight the workings of the capital-gains exemption most clearly. The examples cited later in the paper also use a zero-cost base for the donated property for the same reason. The calculations assume that the individual has a combined federal and provincial marginal tax rate and donations tax credit of 46 percent.

6 This tax change, first adopted on a temporary basis, was made a permanent part of the *Income Tax Act* in 2001.

7 There are also special rules relating to donations of Canadian cultural property, environmentally sensitive land and other special categories.

Table 2: *Net Cost of Selected Charitable Gifts (Based on Present Tax and Credit Rates[a] for Comparability)*

	Listed Securities			
Donation	*Pre-1997 Rules (full capital gains taxed)*	*After 1997 Changes (one half gains taxed)*	*Private Sector Suggestion[b] (gains fully exempt)*	**Cash**
Value of gift	$100	$100	$100	$100
Cost	0	0	0	—
Capital gain	100	100	100	—
Capital gains subject to tax	50%	25%	0%	—
Capital gains tax[c]	23	12	0	—
Tax credit (46% combined)	46	46	46	46
Net tax cost	(23)	(34)	(46)	(46)
Net cost of gift	77	66	54	54
Accrued capital gains taxes forgiven	0	12	23	—
Total tax support[d]	46%	58%	69%	46%

a Based on combined federal and provincial rates and credits.

b Proposed complete exemption for accrued gains on donations of listed securities: see later discussion.

c The capital-gains tax and capital-gains tax foregone is overstated in the tables because if the gift of appreciated securities was not made, the prospective donor might have postponed realizing on the securities for some time; only the present value of this future tax should be considered.

d Total tax support is defined as the federal and provincial tax credit plus the accrued capital gains taxes foregone.

Tax Principles Involved

Most countries extend tax benefits to the donors of gifts to charities and although tax support systems vary considerably, allowing a deduction is the most common approach. However, there are economic principles that can be referred to in considering what degree of support is appropriate. Charitable activities are usually treated as public goods that can be supported both privately out of personal resources and out of general tax revenue through tax deductions or credits. A charitable donation can be considered as a public good because it generates benefits that accrue to people other than the donor, even though it can also be regarded as an item of personal consumption because donors presumably get more satisfaction from the gift than they would from spending the after-tax cost. Five main tax rules emerge from the models:[8]

- The better a charity is at enhancing the quality of life for citizens, the higher the tax subsidy it should receive.
- The less responsive the amount donated is to the after-tax cost of donations, the lower the tax subsidy it should receive.
- If redistribution is a goal, charities to which high-income donors contribute disproportionately — an opera house, for example — should receive a lower tax subsidy than others.

8 See Saez (2000) for a more technical treatment.

- Government grants directly to charities may crowd out private donations and the more important that crowding-out effect is, the higher the tax subsidy should be.
- Unless one argues for going back to a deduction system, there is no theoretical basis for linking the rates of tax support to the rates of income tax, as is done in Canada.

The problem with these tax principles is that they would imply a different level of tax support for different types of charities, or even for each individual charity. An even more compelling difficulty is that the data — more particularly the disaggregated data — necessary for their application simply do not exist.

A common statement used to justify higher tax expenditures in support of donations is that if a one-percent decrease in the after-tax cost of donations generates more than a one-percent increase in donations, allowing the deduction of these donations from taxable income generates more contributions than is lost in tax revenue because of the subsidy. Estimates of this responsiveness effect in Canada vary widely, although the best guess is that on average a dollar in tax support generates more than a dollar of donations and the estimated effect would vary even more for individual charities.[9] However, even if foregoing $1 in tax revenue generates more than $1 in donations, that dollar is not necessarily put to a more efficient use than it would have been had it stayed in the hands of the government and been used to reduce taxes or make other expenditures.

There is relatively little accountability for how the present tax support of charities is used.

Proposals For Expanded Tax Support

Like most assistance delivered through the tax system, there is relatively little accountability for how the present tax support of charities is used. But as anyone who opens their own mail can attest, charities always feel the need of additional resources to carry on their good works: in Toronto alone, the appeals underway by major institutions amount to over a billion dollars. It is, therefore, not surprising that there are a number of proposals — with varying degrees of logic — as to how the tax system could provide even greater assistance to donations.

Full Exemption for Capital Gains on Donations

The most prominent of these suggestions is that the exemption for capital gains on the donation of appreciated listed securities be raised from 50 percent to 100 percent. This would mean that the donor would simply receive a tax credit based on the fair value of the securities with total forgiveness of the inherent capital-gains tax liability.

Proponents of this suggestion argue that this more favourable treatment would simply restore the level of tax assistance that was provided under the tax system of

9 For estimates of this elasticity effect in Canada, see *Working Together: A Government of Canada/Voluntary Sector Joint Initiative: Report of the Joint Tables* (August 1999) — Supplementary Paper C.

several years ago, when tax rates and tax-credit rates were higher and three-quarters of capital gains were generally taxed, instead of the present half. Just as an ill wind always blows some good, the generally happy news of lower personal-tax rates and more favourable capital-gains treatment has effectively increased the after-tax cost of personal giving generally and, more particularly, the gift of appreciated securities.

For example, the gift of securities with a zero-cost base at a time when top marginal personal-tax rates were well above 50 percent and the capital gains inclusion rate was 75 percent, would have generated total tax support of 73 percent of the gift (this is made up of a tax credit of, say, 53 percent plus the forgiveness of one half of the capital gains tax of 39 percent of the gift). Under present tax rates and rules, the amount of tax support has fallen to 58 percent, as shown in Table 2. If a complete exemption were granted on capital gains on donated listed securities, the total tax support would rise to 69 percent (Table 2): this would result in less tax support than the half-gain rule provided in 1998.

The numerous supporters of this proposal[10] argue that this change would bring the Canadian rules on gifts of appreciated securities more in line with those now in effect in the United States and Britain.[11] They also contend that it would induce substantial new donations to charities at a relatively modest cost in forgone tax revenues to federal and provincial governments.

But there are some interesting questions about the fairness of the proposal to completely exempt donations of listed securities to charities from capital gains tax:

- The proposal would only reduce the cost of giving to the recently shrinking number of Canadians who have significant accrued but unrealized gains on their securities holdings; other taxpayers would have no means of accessing the tax break.
- The great majority of those who could take advantage of the change would be upper-income Canadians because capital gains are closely related to income levels; some 60 percent of all capital gains are realized by the approximately 3 percent of Canadian taxpayers with incomes over $100,000.
- Donations to private foundations (which are largely foundations where a single donor and his family have contributed more than 50 percent of the capital of the foundation), are not currently eligible for the half inclusion of capital gains on gifts of appreciated property. If this distinction were carried over in any extension of the half-gain rule, the difference in tax treatment between gifts to private foundations and other charities would widen.

The revenue loss from the proposal is somewhat difficult to quantify, though likely to be relatively modest: the actual federal revenue cost of the present half exemption is reportedly between $15 and $73 million (see Table 1 and discussion

10 Including the Canadian Centre for Philanthropy, the Association of Fundraising Professionals, the Finance Committee of the House of Commons and numerous charities and individuals connected with charities.

11 The Department of Finance argues, in an article in *Tax Expenditures 2002*, that the existing level of tax support on gifts of securities is already equal to that in the United States, but in part this assertion is based on the fact that Canada has higher tax rates.

above). Of course, even more favourable treatment would induce a larger volume of donated securities and hence a larger revenue loss.

Expand Capital-Gains Exemption To Other Assets

The present half exemption from capital-gains taxation on donations to charities only applies to listed securities. The extension of this to other property, such as art and shares of private companies, would open up new opportunities for giving, while unfortunately creating new avenues for tax avoidance with respect to assets that are highly illiquid, making valuations inherently soft, as well as making realization more difficult to the recipients. The federal government has, rather sensibly, been unwilling to expand the exemption.

Increase Rates of Tax Credit

The first suggestion is to grant the higher rate of federal tax credit to all donations, instead of just those over $200. This change would provide an additional federal and provincial credit of about $40 to all those who gave $200 or more, with a substantial revenue loss. But it would not change the marginal support for donations to all those who already give over $200, which is where the great majority of donations is concentrated and is, therefore, likely to have a relatively large revenue cost in relation to the modest additional donations it would induce.

A second suggestion is to raise the federal tax-credit rates of 16 percent and 29 percent, thus providing all taxpayers with treatment that is more favourable than allowing the donations as a deduction. This measure could have a significant effect on donation levels,[12] at the cost of an equally significant loss of tax revenue: a 30-percent increase in the rates of credit would reduce federal and provincial tax revenues by a minimum of $650 million annually and likely much more if, as anticipated, the measure induced additional giving. It is argued that this approach would be fairer than the extension of the capital-gains exemption on gifts of appreciated securities because it would provide advantages to a broader range of donors and likely charities, as well.

However, the proposal opens up the same basic question as can be raised concerning the present capital-gains exemption on donated securities: how much public support is justified for charitable gifts to private institutions? The present system supposes that individuals, even with the tax advantages provided, still face a substantial personal cost in making donations. If this personal cost is reduced to too low a level, individuals may have less of an incentive to enquire about the purposes and conduct of the organizations to which they are contributing, with some loss of accountability.[13]

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12 In a 2000 survey by the Canadian Centre for Philanthropy, 49 percent of Canadians said that they would contribute more if offered a better tax credit, up from 37 percent in 1997.

13 A further suggestion is that volunteers be entitled to a tax credit in respect of the time they donate to charitable endeavours, but this would involve an administrative morass and a questionable theoretical basis.

Should We Provide More Tax Support For Canada's Charities, And If So, How?

Those who argue for additional tax support for charities — in one form or another — often refer to the relative efficiency, in monetary terms, of charitable work, being levered as it is by huge amounts of donated volunteer time. It is also pointed out that, if the alternative is to make greater use of focused government grants, the success rate for this direct government funding is not overly positive.

In the end, the case for both the present and possible additional tax support for charities rests on an assessment on the one hand of the relative benefits which charitable activity could provide for our society, and on the other, of the detriment of the loss in government revenue from its tax support and the costs that this imposes through higher general tax rates and reduced spending on other programs. There is no simple answer to this balancing equation: 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.

Overall, our judgement is that the *general* tax support for charities is adequate and there is no strong case for increasing it at this time. As noted above, Canada's tax-credit system is for many already more generous than a deduction system because the tax-credit rate is equal to the highest marginal tax rate for all donations above $200, regardless of the donor's income. Further, US evidence[14] shows that tying the tax-credit rate to the income-tax rate generates, in most simulations, more generous subsidies than is optimal.

There are concerns about the conduct of some charities: the ratio of fundraising costs to resources raised varies dramatically.

At the same time, there are significant concerns about the conduct and accountability of a number of charities: the ratio of fund raising costs to resources raised varies from modest levels in some charities to well over 50 percent in others. There are also reports of poor governance, questionable fundraising techniques and high administrative costs and inefficiencies.[15] The ethical fundraising and financial accountability code developed by the Canadian Centre for Philanthropy could serve as a model for reform, augmented by a system of voluntary accreditation.[16]

Furthermore, there should be better data available to the public on the operations of charities, both in the aggregate and individually. While the diversity that is the hallmark of charities needs to be respected, charities use public resources and should be held accountable for that use.

In light of these concerns about the accountability and conduct of some parts of the sector and in light of the high tax expenditure costs associated with an increase in tax-credit rates, consideration of such a change should be postponed until further actions are taken to enhance the transparency of charities and improve their governance. Because such developments would require research and

14 See Saez (2000).

15 See, for example, a series in the *Toronto Star*, November 12–16, 2002.

16 See Report of Panel on Accountability and Governance in the Voluntary Sector (1999).

extensive consultation, any consideration of a major enhancement of tax support should be put on hold at least for the moment.

However, the proposal to completely exempt donors from capital gains on the gifts of appreciated listed securities is less subject to these reservations, even though it is mostly based on practicality rather than theoretical arguments. For one thing, because of the importance of gifts of securities in monetary terms, donors usually demand better accountability measures from the organisations they give to and in many cases personally ensure that the money is put to efficient use. Also, this measure would have relatively modest costs in terms of foregone tax revenue — the donation of an estimated $200 million of listed securities in 2000 cost between $15 and $73 million in lost tax revenue.[17] The change would also slightly reduce the present adverse lock-in effect of capital-gains taxation, which prevents individuals with appreciated assets from reallocating their investments.

It is true that the measure is likely to reduce the costs of donations more for upper-income individuals than for others. However, as long as the gifts benefit the community as a whole, this should not unduly concern us.[18] While leaving in abeyance the issue of whether and how some additional general tax support for the sector might be provided in the future, the capital-gains extension is a doable change that would provide appreciable benefits at modest costs and within a supportable public policy framework.

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17 See Table 1 and discussion following.

18 John Dillinger, when asked why he robbed banks, is said to have replied: "Because that's where the money is." Any proposal to substantially enhance charitable giving in Canada has to recognize that increased donations will come primarily from upper-income Canadians.

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