TD Bank Financial Group

TD Economics

Special Report

May 1, 2007

DONATING SECURITIES MAKES GOOD FINANCIAL SENSE

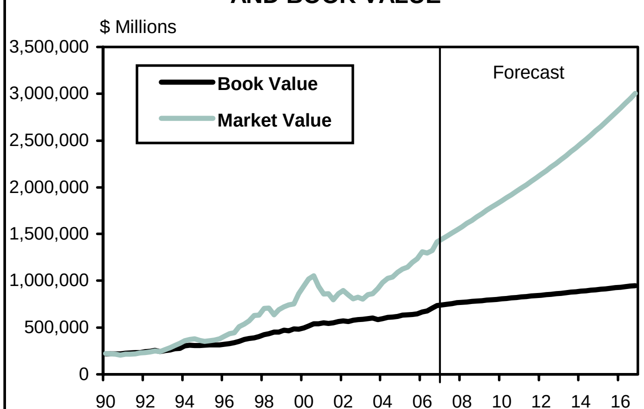
May 2nd marks the one-year anniversary of the government decision to allow donations of publicly-listed securities to public charities to be exempt from capital gains taxation. At the time, TD Economics cheered this decision loudly, arguing that it would provide a considerable incentive for Canadians to make contributions and might significantly boost financing of charitable organizations.

Data showing the donor response are not yet available, but the anecdotal evidence suggests that the charitable sector has benefited significantly. This can be best illustrated by the fact that many charities moved quickly to develop policies and practices to handle the expected increase in donations of securities. There was also media coverage about a number of very large donations to specific charities after the new rules were announced. We expect that when the data are finally published they will show a surge in donations of shares in 2006. However, the pace might moderate in 2007, since some individuals may have delayed making stock donations in 2005 until 2006 in anticipation of the new capital gains tax exemption.

HIGHLIGHTS

- **Canadians still tend to think of cash when making donations, but the giving of securities is highly attractive and often superior to cash.**
- **Investors have accumulated close to $700 billion in capital gains in their stock portfolios and this could reach close to $2 trillion over the next decade. Stocks donated to charities are now exempt from capital gains taxation.**
- **Donations of shares from stock options can be advantageous, but must be done within 30 days of exercise**

PERSONAL SHARE HOLDINGS - MARKET AND BOOK VALUE



Forecast by TD Economics

Source: Statistics Canada/Haver Analytics, TD Economics

Putting aside the volatility in the annual figures, there is every reason to believe that donations of securities will prove strong in the years ahead, but there is still a sense that greater public recognition of the advantages of doing so is needed. Many Canadians still tend to think of cash first when considering charitable giving, despite the fact that in many cases it makes more sense to make contributions of securities. In the sections that follow, we will highlight the huge pool of securities that can be drawn upon for charitable giving, outline the powerful incentives for donating securities and review how holders of stock options may wish to take advantage of the capital gains exemption on donations.

Canadians have accumulated vast capital gains

As a starting point, it is important to illustrate why the exemption of capital gains taxation for donations is significant. Statistics Canada estimated that Canadians held shares worth a market value of $1.4 trillion at the end of 2006. The book value of these shares was a little more than $0.7 trillion, meaning that half of the total market value represented capital gains and they have been a rising share of the total over time.

Looking ahead, the capital gains pool will likely continue to expand. Our conservative estimate is that the total return on the S&P/TSX, excluding dividends, should average 5% per annum over the coming decade. Under this assumption, and allowing for continued net purchases of securities, the total market value of shares outstanding could exceed $3 trillion in ten years time and as much as two-thirds of the total could represent capital gains.

Federal and provincial governments provide individuals with a preferential tax treatment on realized capital gains, so that only 50% is treated as income for tax purposes. Nevertheless, the implication is that Canadians will pay enormous taxes when these securities are eventually sold. Moreover, the outlook is for financial returns to remain relatively modest by historical standards, implying that tax minimization should be a priority for investors.

Donating shares is very attractive and better than cash

If individuals have an inclination to make charitable donations, they can do so and at the same time minimize tax payments by giving securities. Contributing securities is highly attractive because the individual receives a tax credit for the donation and also avoids paying taxes on the capital gains accumulated on the securities. Donating securities directly is also superior to selling the securities and then donating the cash received.

An illustration is useful. Consider shares that are bought for $400, but have appreciated to a value of $1,000. If the shares are sold and then the cash donated, the individual will have a capital gain of $600, which will be taxed as if 50% were income. For this example we will assume the individual is in Ontario with a combined federal-provincial marginal tax rate of 46.41%. If so, there would be capital gains taxes of $139.23, leaving the investor with a donation of $860.77, for which they would receive a tax credit of $399.48. [Please note that in this example we are applying the top marginal tax rate. Under current tax rules, the first $200 of donations receive a tax credit based on the lowest marginal tax rate, while donations in excess of $200 receive a tax credit at the highest marginal tax rate. The assumption is that donors of shares will rapidly exceed $200, so the higher tax rate is the relevant one.]

SUPERIORITY OF DIRECT DONATIONS OF SHARES

	Shares Sold & Cash Donated ($)	Shares Donated Directly ($)
Current Value of Shares	1000.00	1000.00
Purchase Price of Shares	400.00	400.00
Capital Gain	600.00	600.00
Capital Gains Taxes*	139.23	0.00
Funds Available for Donation	860.77	1000.00
Tax credit	399.48	464.10
Benefit to Charity	860.77	1000.00
Tax Benefit to Donor	399.48	464.10
Profit on Investment of Donor	-0.52	64.10

*For illustrative purposes we have used the Ontario combined federal and provincial tax rate of 46.41%

Now consider the direct donation of $1,000 worth of shares. The tax credit at the 46.41% tax rate is a larger $464.10 and the $139.23 of capital gains taxes is completely avoided. So, the total benefit to the charity is $1,000 and the total benefit to the investor is more than $600. Both the charity and the donor are better off when the securities are directly given to charity than when the shares are first sold and the after-tax proceeds donated.

Moreover, in this particular case, since the shares were bought for $400 and the tax credit was $464, the investor made a profit of more than $60 relative to the initial purchase price in addition to the $1000 donated to the charity. It should be stressed that a profit will not always occur, as the accumulated capital gains must be 100% larger than the initial cash purchase. However, this is not rare. Remember that capital gains already account for half of the total value of the market share of stocks held by investors and are likely to be a larger share of the total in the future.

Give the securities with greatest capital gains per share

If there is a charitable intent, the key recommendation is that donors should choose to give the securities that have experienced the greatest capital gain per share. A great illustration comes from the holders of shares in demutualized life insurance companies. On March 12, 1999, legislation was enacted allowing life insurance companies to issue shares to the public – or “demutualize”. Demutualization is the process of converting from a mutual company, owned by its policy holders, to a company with common shares, owned by its shareholders. The implication was that policy holders had a choice to receive shares of the company or the equivalent in cash. For those that opted for shares, the acquisition cost was effectively zero, so all of the value is capital gains. Clearly, some of these investors might want to minimize their tax hit when the stocks are sold.

Canadians may also want to make donations when unexpected taxable events occur. A great example of this is the experience of some stock investors when there have been large-scale merger and acquisitions (M&A). If an M&A deal is structured so that shareholders of the acquired Canadian company are given shares of the Canadian purchasing firm, there is usually no taxable event. But, if the deal is structured as a cash purchase (or shares of foreign companies are involved), shareholders of the acquired company typically must pay taxes on the capital gain. Investors that find themselves in this unanticipated situation may not have planned for the tax payments required to Revenue Canada and may want to reduce their tax liability by making charitable donations.

The gift of options can also be advantageous

The May 2, 2006 Federal Budget also allowed donations of shares acquired by exercising employee stock options to be exempt from capital gains taxation. Canada's largest corporations make heavy use of stock options. According to Watson Wyatt, 98.6% of companies listed on the S&P/TSX Composite Index in 2003 had stock option plans.

Again, Canadians tend to think of donating cash first, but other choices such as giving options can be advantageous. When stock options are exercised, any gain is considered employment income and it is typically taxed at capital gains tax rates. In order to minimize the tax hit, stock option holders may wish to donate some of them to charities.

However, a couple of simple rules must be followed. First, the options must be exercised and the acquired stock donated within 30 days and in the same calendar year. Second, due to regulations that determine how the average price of securities are calculated for tax purposes, it is inadvisable that shares of the same company be bought or sold between when the options are exercised and the donation occurs.

If an executive has a charitable intent, there can also be a diversification argument for donating options as part of an effort to rebalance portfolio holdings. A core belief in financial planning is the importance of diversification. However, salaries, bonuses, stock options, and employee stock participation plans mean that most executives, and most employees for that matter, are overly reliant upon the financial performance of one firm. This arrangement gives the executive a strong incentive to work on behalf of shareholders, but it also leaves them heavily leveraged and exposed to company-specific shocks. At some point, a portion of the company shares and options should be sold or exercised to reduce this exposure. If the individual has a desire to make charitable donations and wants to reduce the tax hit when rebalancing their portfolio, donating shares acquired by exercising employee stock options may be a very attractive choice.

Donations of securities and options are still an act of generosity

Finally, some readers may be getting the sense that the recommendation of donating securities is purely for tax minimizing purposes. It is important to stress that donations are still an act of generosity. In each and every case, the individual would be financially better off selling the securities for cash and retaining the funds for personal spending or investment. The tax credit and the elimination of capital gains taxation are not sufficient to fully offset the value of the securities. However, the federal and provincial governments have deliberately reduced the financial burden of giving by providing tax incentives. Donors should not feel guilty about taking advantage of the preferential tax treatment, since it is the intent of governments to help encourage greater contributions to charities. In the end, the donations of securities are good for charities, they are an act of generosity and caring on the part of Canadians, and it is the purpose of the recent government legislation.

Craig Alexander, VP & Deputy Chief Economist
416-982-8064