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Planned Giving: know the rules, seize the opportunities!

by **DeWayne Osborn, CGA, CFP**

This article will briefly define some of the more significant legislation involving donations that has been enacted since 1997. Once defined, I will provide examples of how the legislation is being successfully applied in a broad, charitable giving context today.

While the primary focus of the article is on advisors, donors should also be able to use the information in their own philanthropic planning. The examples presented will be relevant to a broad application. It is up to the advisor/donor to refine the strategies to fit their unique situation.

Review of Significant Legislation 1997-2011

Definition of a Gift

For decades, the courts have repeatedly defined a charitable gift as a voluntary transfer of property, not services, to a registered charity without benefit to the donor. The charity must accept the property to complete the gift. In 2004, the Government of Canada (“Finance”) passed legislation that allowed some benefit to attribute to the donor provided that the “advantage” did not exceed 80% of the fair market value (“fmv”) of the total contribution. The difference between the fmv of the contribution and any advantage received is the “eligible amount” – the number the donor claims on the tax return.

A simple example illustrating eligible and advantage would be the transfer of a \$500,000 piece of land to a charity where the charity agrees to pay \$200,000 to the donor. The advantage would be \$200,000, and the eligible amount would be \$300,000. If the charity paid more than \$400,000 for the land, then there would be no eligible

amount because the advantage exceeded 80% of the fmv of the total contribution¹.

As we shall see later, the ability to use advantage can be a powerful tool for advisors!

Contribution Limits

Individual and corporate donors can claim charitable gifts up to 75% of their net income in the year of the gift or can carry forward the credit/deduction for the next five years. In the year of death, an individual making a gift via the will (e.g. bequest) can claim the charitable donation credit up to 100% of their net income in the year of death AND carry back any unused donation credits to 100% of the previous year’s net income².

Reduction in the Disbursement Quota for Registered Charities

Prior to March 4, 2010, charities had to spend a prescribed amount every year in order to maintain their registration as

a charity. The original legislation dated back to 1976.

The formula to determine the prescribed amount is called the Disbursement Quota (“DQ”). Generally speaking, a charity had to spend 80% or more of the tax receipted gifts from the previous year, plus an additional amount equal to 3.5% of the 24-month average fmv of all assets not used for charitable activities or administration of the charity (e.g. investments).

For example, in 2003, a church with \$200,000 in tax receipted gifts in 2002, and \$1 million in investments not used for charitable activity or administration, the church’s 2003 DQ would be 195,000³.

Why mention DQ in this article? For fiscal periods ending after March 4, 2010, the DQ is now 3.5% of the 24-month average fmv of assets not used for charitable activities or administration. In the church example, the DQ went from \$195,000 to \$35,000. Such a dramatic

1. If the advantage exceeds 80%, provided the donor writes the Minister of National Revenue and proves donative intent, the eligible amount can be less than 20%.

2. In a carry back situation, the donor’s contribution room of 100% of net income in the previous year is reduced by any charitable donations claimed in that year.

3. $\$200,000 \times 80\% + (1 \text{ million} \times 3.5\%)$

Planned Giving: know the rules, seize the opportunities! (cont'd)

change offers unprecedented flexibility for donors seeking strategies to satisfy their philanthropic wishes. As we shall see later, the ultimate expression of maximum donor philanthropic flexibility is the private foundation.

Excess Corporate Business Holding Regime and the Private Foundation

Before donors and or advisors race off to setup private foundations, a clear understanding of this all pervasive legislation is vital. Excess Corporate Business Holdings ("EBH") does not permit any private foundation to own more than 20% of any share class either on its own, OR in combination with other non-arms length persons referred to as Relevant Persons⁴. The private foundation is permitted to own a nominal amount defined as 2% of any share class. Provided the private foundation owns 2% or less, it does not matter how much is owned by other relevant persons. If the private foundation and any relevant persons own more than 20% of any share class, the private foundation must sell its holding to 2% or less, or the foundation plus the Relevant Persons must reduce their combined holdings to 20% or less.

In other words, it is not possible for a donor to roll is or her privately held shares into a private foundation IF the long-term intent is to hold onto them. If the plan is to redeem the shares anyway as part of a business exit strategy or estate

planning etc., then provided the shares can be sold quickly (e.g. by the next fiscal period) from the date of the gift, use of a private foundation may be an option for consideration.

Zero Capital Gain Inclusion Rate for Gifts of Listed Securities

In 2006, donors making gifts of appreciated publicly traded securities⁵ to public charities (not private foundations) were not required to report any of the capital gain on their tax return. The capital gain inclusion rate was reduced to zero. Corporate donors were now able to include the entire capital gain from donations of appreciated capital property in the company's capital dividend account ("CDA") for payment as tax free dividends to shareholders.

In 2007, donors to private foundations were afforded the same zero inclusion rate for publicly listed securities.

Combining gifts of corporately owned listed securities with new or existing corporately owned life insurance strategies has led to some simple, yet very tax effective ways to make charitable donations. An example demonstrating this model is shown below.

Gifts of Flow Through Shares and Flow Through Limited Partnerships

Flow through Shares ("FTS") and Flow Through Limited Partnerships ("FTLP") are special securities where the mining or

resource company that issued them did so pursuant to an agreement that allows the company to "flow" certain exploration and mining expenses out to shareholders to deduct on the shareholder's personal tax return. In essence, 100% of the initial investment in the FTS or the FTLP can be written off by the shareholder over a 4 to 24 month period. In 2011, an additional 15% federal mineral exploration tax credit was made available until March 31, 2012⁶.

The tax benefit of investing in FTS or FTLP is that once the investment is written off, the security has a cost base of nil. Therefore, when sold by the shareholder, the amount received for the security is all capital gain subject to the normal 50% inclusion rate for taxation purposes.

If the FTS or the FTLP converted to a publicly listed share or mutual fund, donors using this property to gift to charity received a deduction of the initial investment, a donation tax credit for the fmV of the gift, and no tax on the capital gain resulting from the gift – a triple win!

Budget 2011 changed this triple win by restricting the zero inclusion rate to that portion of the capital gain where the fmV of the gift exceeds the original cost. Given that FTS often sell at a premium, it is not expected that the fmV of the FTS when gifted will exceed the original investment.

4. CRA document detailing the EBH: <http://www.cra-arc.gc.ca/E/pub/tg/t2082/t2082-10e.pdf>. The *Income Tax Act* defines non-arms length persons as Relevant Persons.

5. Generally speaking, any share, right, warrant, etc., listed on a prescribed stock exchange including all major international exchanges. Mutual funds and segregated funds are also considered to be listed securities.

6. Announced in the June 6, 2011 Federal Budget.

Planned Giving: know the rules, seize the opportunities! (cont'd)

Examples / Case Studies

This section will present some examples of gifting strategies being used successfully today in several Canadian provinces. These strategies are not overly complicated and are intended to be applicable to a wide range of donors. Depending on the donor's unique situation, possible "sweeteners" such as insurance can be added to enhance the gift.

Except where specified to the contrary, all examples assume an Alberta resident donor with a top individual tax rate of 39%. Any reference to a corporate donor will be clarified in the example. The charitable donation tax credit is 50% and the donor can afford to write off the entire credit in the year of the gift.

Bequest

Bob and Mary are in good health, have sufficient wealth to support their lifestyle, are not concerned about their kids' financial affairs, and own a small successful business in Alberta. They are charitable in nature and want to help their church's long term survival through a significant gift to be invested and the income used to support the church's activities (e.g. endowment).

Without first consulting their financial advisor, they establish a residual bequest of \$1 million cash to the church. When they both are gone, the \$1 million tax receipt will save them \$500,000 in taxes. The after tax cost of the gift will be \$500,000.

What possible sweeteners could be considered? Use of corporately owned life insurance to fund the bequest might make a lot of sense. Assume the company purchased a \$1 million life policy on the principle shareholders (Bob and Mary). The insurance requires \$37,200 annual premiums for life, where life is defined as 12 years, at a 4.5% interest rate. The adjusted cost base of the life insurance policy is expected to be nil, hence the full \$1 million in face value can flow into the Capital Dividend Account ("CDA").

Upon their death, the insurance policy pays the company the \$1 million in death proceeds. The company pays out the \$1 million as a tax free capital dividend to the estate, and the estate funds the \$1 million bequest to the church. Once again, the deceased saves \$500,000 in tax on their final tax return.

A significant benefit of using this strategy is the lower after tax cost to make the same gift. Using a life policy based on a life expectancy of 12 years and a 4.5 interest rate, the today cost of the premium payments to fund the \$1 million insurance is \$354,500⁷. The \$500,000 in tax savings converted to today's dollars is \$294,800. Assuming Bob and Mary pay 17% on any taxable dividends received, the after tax cost to pay them the \$354,500 if they did not buy the insurance is \$294,300 (all figures rounded). Therefore, the after tax cost to gift \$1 million based on this illustration is nil⁸. The today value of the \$500,000 in tax savings is roughly equal

to the present value cost of the insurance over a normal life expectancy.

When considering gift through a personal corporation, a great deal of financial and accounting expertise is involved. Donors are strongly advised to consult their advisors prior to considering any gift strategy, much less one using a personal corporation.

Donate to Acquire

Another common gift strategy using publicly listed securities is to gift a portion of the portfolio to charity, then sell another portion for other uses. In essence, you create a tax shield to allow for other taxable transactions such as a portfolio re-positioning, or lifestyle needs (e.g. shopping).

Martha's advisor was concerned over the growing capital gain situation in her portfolio of mutual funds. Given Martha's age and financial situation, her advisor needed to re-position her portfolio, but knew Martha would not want to pay the tax on the resulting capital gains.

The advisor knew that Martha was philanthropic and was thinking about a \$100,000+ gift to her favourite charity. After considering her investments, he decided to illustrate a potential gift using 10,000 shares of a publicly listed company with a fmV of \$60 and a cost base of \$10.

The advisor did the math and presented the following strategy to Martha:

1. Gift 2,460 shares to the charity, and sell the remaining 7,540.

7. PV of \$37,200 payments over 12 years at 4.5% = \$354,500.

8. \$294,800 in tax savings less the \$294,300 in after tax cost to payout the \$354,500 as an Eligible Dividend.

Planned Giving: know the rules, seize the opportunities! (cont'd)

2. The resulting tax credit of \$147,600 would offset the \$73,515 in taxes from the sale⁹.
3. Martha would then re-invest the \$452,400 tax free cash in a manner that was better suited for her situation¹⁰.
4. Alternatively, Martha, a lifelong saver, could also spend some of the cash on something she always wanted, like a nice cruise!

Gift of Flow Through Securities:

While gifts of Flow Through Shares ("FTS") is not really a new strategy, with the substantive rule changes in the 2011 Budget, it is worth demonstrating the before and after affect on this gift strategy. **The table below** is an example for Alberta and its 39% tax rate and 50% charitable donation credit (AKA the Alberta Advantage). The \$100 security was purchased at a 20% premium, then donated at a later time for \$100 fmv.

As you can see, compared to the \$50 cost to donate \$100 in listed securities with no

cost base in Alberta (likely very rare security), despite the new rules, using FTS that have converted to publicly listed securities can still be very tax effective method to make a charitable gift. As mentioned before, additional and provincial credits can further enhance the situation.

Gifts Using Privately Held Shares:

As mentioned earlier in this article, Excess Corporate Business Holdings ("EBH") prevents private foundations from owning too much of any one share class. However, such restrictions do not apply to public charities accepting privately held shares if all of the following is true:

- The property is a share;
- The charity that receives the non-qualifying security (share) is not a private foundation;
- The donor is at arm's length to the charity; and
- The donor is at arm's length to each of the charity's directors/trustees, officers and like officials.

If any of the above is not true, the public charity would have to sell the shares within 60 months before a tax receipt could be issued¹¹.

Consider this example:

Bob age 80 is a recent widower and retired from his business for many years now. His spouse did not own shares of the business, and most of her assets transferred to him as the last survivor. Bob's children have been running the business for some time and it is doing very well.

Bob is the sole shareholder of \$2.5 million of preferred shares put in place years before when the estate was frozen and common shares were issued to the children. The redemption value of the preferred shares is fixed. The preferred shares pay him a reliable dividend that he does not need. Furthermore, on advice from his advisor, the company took out a fully paid up \$2.5 million life insurance policy on Bob's life to redeem the shares from his estate over time.

Gift of Flow Through Securities ("FTS")

	FTS Prior to March 22, 2011	FTS Post March 22, 2011	Non FTS Listed Security \$100 fmv, nil cost
Price per share for FTS (20% premium)	\$120	\$120	\$100
FTS deductions (fed/prov)	-\$39	-\$39	\$0.00
Capital gains tax on gift (\$100 fmv, cost is nil)	\$0.00	\$19.5	\$0.00
Value of donation tax credit	-\$50	-\$50	-\$50
Net after -tax cost	\$31.0	\$50.5	\$50.0
Donation amount	\$100.00	\$100.00	\$100.00
Government tax support % as a % of donation	89%	69.5%	50%

9. $2,460 \times \$60 \times .5 = \$73,800$ tax credit $> (7,540 \times (\$60 - \$10) \times .5) \times .39 = \$73,515$ in new taxes.

10. $7,540 \times \$60 = \$452,400$.

11. The share would be a Non-Qualifying Security. The value of the gift is the lesser of fmv at the time of the gift and the actual sale proceeds.

Planned Giving: know the rules, seize the opportunities! (cont'd)

When Bob lost his spouse to a long illness, he was particularly moved to immediately help fund research to help others afflicted with her disease.

After consulting his advisor, here is the strategy they devised:

- Bob could gift the \$2.5 million in preferred shares to the local community foundation to establish a fund in his spouse's memory. This will result in a capital gain to Bob equal to the difference between the fmV and the adjusted cost base of the shares.
- After a proper valuation of the shares, the foundation issued Bob a \$2.5 million tax receipt which completely eliminated the tax on the gain from the gift of the shares, and left some additional credit for Bob's use over the next 5 years.
- The foundation was made aware of the life insurance to fully redeem the shares when Bob died. Although the preferred shares were fully redeemable, the foundation agreed to wait until redeemed by the company when Bob died¹².
- The annual dividend on the preferred shares would be paid to the foundation to be used for current granting from his wife's fund.
- The proceeds from the insurance were used to redeem the preferred shares in the fund and it was renamed in both of their names.
- The non-taxable portion of the gain from the gift of the shares can be added

to the company's CDA for payment to shareholders tax free¹³.

There are a multitude of approaches to proper estate planning. Where possible, a successful approach taken by many advisors when working with philanthropic clients is to insert the client's favourite charity into an existing, well understood strategy. In this case, Bob was not overly philanthropic when the initial estate freeze was implemented. However, as with many planned gift donors, the loss of his spouse changed his overall approach to philanthropy.

Term Annuities for Valuations

A 78 year old executor called the church wanting to close out his friend's estate. The terms of the will provided for \$8,000 per year to be paid to the church for 15 years to fund specific projects. The church was largely run by volunteers and did not have the accounting resources to effectively deal with this situation. Furthermore, the church did not know how to reasonably value the payment stream to allow for a lump sum payment so the Executor could close the estate.

As a member of the planned giving committee for the church, a financial advisor proposed the following solution: a 14-year term certain annuity¹⁴. The annuity would make a lump sum payment of \$86,500 for an annuity to pay \$8,000 annually to the church on a specific date was proposed.

This solution solved all of the issues:

- The valuation of the annual payments was resolved using a commercial annuity contract;
- The Executor had his lump sum gift eligible for a full tax receipt; and
- The church did not have any accounting issues.

Endowments to Pay Family

Bill age 88 and his wife age 76 have two kids ages 55, and 53. Bill had heard of a donation strategy called a gift annuity and wanted to use it for his donation of \$200,000 to his alma mater. He wanted the proceeds to pay his wife first, then his children equally for life.

A gift annuity is where the donor makes a contribution of non-registered funds (e.g. cash) to a charity, and the charity agrees to make fixed payments to the donor for life. The charity then takes 70-75% of the contribution and purchases an annuity contract to make the payments on its behalf. The eligible amount to the donor is the difference between the amount contributed and the cost of the annuity (advantage).

After some thought, the university sent the following proposals:

- Contribute \$100,000 to the university now for a gift annuity on his wife's life alone. The school will use \$75,000 to acquire the annuity, and retain the \$25,000 as a gift of cash.

12. If the shares were gifted to Bob's new private foundation, they would have to be sold within 2 fiscal periods from the date of the gift. Therefore, the private foundation was not a solution for the preferred shares.

13. The proceeds from the life insurance policy will also be added to the CDA as part of the original exit strategy.

14. The estate made the first payment, thus 14 more were required. Foundations can use this tool in this manner since no debt is being incurred.

Planned Giving: know the rules, seize the opportunities! *(cont'd)*

- Bill gets a \$25,000 tax receipt today to eliminate \$12,500 in taxes this year.
- Bill's wife adds a bequest in her will for the second \$100,000 to be used in a similar manner, but on the children's lives.
- Bill's wife receives another \$25,000 tax receipt for her final return saving another \$12,500 in taxes.
- In summary, a \$50,000 gift to the university, \$25,000 in personal tax savings, and a lifetime of income to his wife and children.

Alternatively, Bill could have gifted the entire \$200,000 to the university to be invested in an endowment account with the annual payout to be made to his wife

and children¹⁵. An actuary is hired to value the lifetime payments to the spouse and children. The actuary determines that 40% of the \$200,000 total contribution is the eligible amount. Therefore, the university issues a tax receipt to Bill in the amount of \$80,000¹⁶ thus saving him \$40,000 in taxes today.

The question is: how could this gift be sweetened? For example, how much insurance could be purchased with \$40,000 using insured person's age 53 and 51? Another question could be: what if the wife does not care about the university as much as Bill did?

Conclusion

As you can see, there are a multitude of options to consider when a client/donor wants to help a charity, and no two solutions are the same. In an ideal philanthropic world, the advisor's role is to understand that being charitable can also be in their client's best interests. Financial advisors should be willing to help their clients give away their assets in a tax effective manner, while preserving their financial objectives. Furthermore, charities are expecting financial advisors to know and understand the rules governing charitable gifting.

As the wealthiest generation in history heads into their "golden years" of charitable gifting, time will tell if financial advisors, registered charities, and all levels of government can work together to secure and use charitable donations for the betterment of our communities and the people that live in them.

15. The university typically pays 4 to 5% of the fmv of its investments for programs at the school. In this case, it would make the same payment to Bill's wife and children.

16. \$200,000 X 40%.

About the Author



DeWayne Osborn CGA, CFP is Lawton Partners' General Manager, Chief Compliance Officer and in-house expert on charitable and planned giving. DeWayne is one of Canada's leading authorities on planned giving. This makes him a valuable asset to the firm when it comes to advising clients who want

to create meaningful financial goals that affect positive change in the lives of those around them.

Before joining the firm in 2000, DeWayne worked for the Health Sciences Centre Foundation, one of the many highlights of his

Lawton Partners

experience serving in senior positions for non-profit organizations. This expertise, coupled with his professional knowledge as a Certified Financial Planner (CFP) and Certified General Accountant (CGA), has made DeWayne a highly sought-after public speaker and consultant on the financial complexities and philanthropic benefits that can be achieved by applying tax-effective strategies for gifting real property, cash, securities and life insurance products.

DeWayne also provides resources and assistance to financial advisors interested in developing planned gift opportunities for their philanthropic clients, and welcomes feedback from advisors or charities at anytime.

The Calgary Foundation Value Proposition

Our Guiding Principles:

- charitable gift planning
- 360° granting expertise
- transparent governance
- proactive community leadership
- efficient investment stewardship
- active intelligence gathering
- community accountability

To discuss charitable gift giving options, contact

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PROFILE: Laily Pirbhai

Appointed as Vice President, Donor Engagement with The Calgary Foundation, in September 2008, Laily was recruited to the organization as a Director in the fall of '06 to lead and manage the rapid & complex growth in the area of family & legacy philanthropy.

Laily has an extensive tenure in private, public, and charitable sectors having served most recently as a Director Business Development for the Calgary Health Region, Director of Major Gifts at the Calgary Health Trust and in various Senior Management roles at RBC Financial Group.

Over the past 25 years, Laily has held formal and informal leadership/board/committee positions in a variety of local, national, and international philanthropic, business and community organizations. She is an active board member & volunteer with many organizations including the Aga Khan Development Network and Rotary Club of Calgary.

A graduate of the Leadership Calgary Class of 2004, Laily is a lifelong learner and holds many accreditations and active industry and association memberships. Her academic achievements include an Undergraduate Degree in Sciences, a Fellowship with the Institute of Canadian Bankers, an MBA in Financial Services, and an Associate of the CAGP Advanced Gift Planning program.

