



Gifts Flow-Through Securities... Can Save You Tax

Reduce your capital gains cost through gifting your securities.

Do you make large charitable donations? Do you frequently sell and realize capital gains on which you have to pay tax? If so, you may be able to reduce your capital gains tax by gifting these securities directly to a registered charity.

How is this possible?

In the 2008 Federal budget, the government continued to expand on the series of incentives to increase giving to registered charities and other qualified donees. The 2006 federal budget eliminated the capital gain tax normally resulting on the gifting of publicly traded securities. The 2008 budget broadened the incentive to include certain exchangeable securities, flow through securities and certain securities that are partnership interests.

What's a flow-through security?

A flow through security is a long-standing source of equity for Canadian mining and resource companies. Resource companies typically have huge up-front exploration costs and little or no revenue. That means they don't need the tax deductions they would incur as income-generating companies. To finance that exploration, they'll issue shares and allow the tax deductions to "flow through" to investors. These deductions (called Canadian Exploration Expense or CEE) reduce the investor's tax cost of the shares. When exploration is complete, typically 2-3 years later, the shares are usually converted, on a tax-deferred basis, to publicly traded securities. Capital gains tax liability on them is often significant. That's when they can be donated to charity to produce the advantages that we

will describe as follows.

Why does it make sense to gift flow-through securities?

Recently, Canada Revenue Agency has released several advanced tax rulings which addresses the "gifting arrangement" whereby flow-through securities are donated to charities by individual donors. The structure is designed to reduce the donor's cost of giving by taking advantage of the CEE as well as the elimination of tax on capital gains on the donation of the publicly listed shares to charities.

The gifting arrangement considered by CRA was structured as follows:

1. A donor, wishing to make a donation to a charity of its choice, opens and funds a brokerage account.
2. Flow-through shares are purchased on behalf of the donor, who then immediately donates them to a charity or charities that have been designated by the donor. The shares are publicly listed and have a fair market value independent of their CEE entitlement, and are subject to a four month hold period during which they may not be traded without restarting the hold period.
3. The charity immediately sells the donated shares to a pre-arranged third party buyer, usually a financial institution.
4. Upon acquisition of the flow-through shares, the donor may deduct CEE renounced in respect of such shares, and when the shares are donated,

Ottawa Office

301 Moodie Drive, Suite 400
Ottawa, Ontario K2H 9C4
T (613) 820-8010 F (613) 820-0465
ottawa@collinsbarrow.com

Manotick Office

1136 Clapp Lane
Manotick, Ontario K4M 1A3
T (613) 692-2553 F (613) 692-2995
manotick@collinsbarrow.com

Queensview Office

2725 Queensview Drive, Suite 500
Ottawa, Ontario K2B 0A1
T (613) 226-5661 F (613) 226-3141
queensview@collinsbarrow.com

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the donor receives a charitable receipt equal to the cash amount actually received by the charity when the shares are sold. This is equivalent to the fair market value of the shares on the date the shares are donated and subsequently sold to the third party. The amount will generally be at a discount to the trading price of the flow-through shares, as the third party buyer will assume the hold period risk and this is reflected in the price paid for the shares.

5. The gifting arrangement is organized and promoted by a taxable Canadian corporation.

By gifting your shares directly to your favourite charity rather than selling the shares you will have saved \$2,250 in tax on your capital gain. Generally, if you are going to make a donation and you are also selling securities, you should consider donating the securities to the charity instead.

If I donate securities, how will my taxes be reduced?

This is probably best explained by an example. Let's assume you wish to make a gift to your favourite charity of \$10,000. You are going to dispose of a flow through security which you have held for 2 years. The shares are currently worth \$10,000. You originally paid \$10,000 for the shares on purchase, but received a flow through deduction of \$9,700 in over the last two years. The inherent capital gain is \$9,700 which at the highest marginal tax rate would attract \$2,250 of capital gains tax.

From the point of view of the donor, the combination of the CEE deduction and the elimination of the capital gains of the donated shares (whose cost base is very close to nil) reduces the after-tax cost of donating dramatically.

Initial cost of flow- through security	\$ 10,000 – immediate write off is approx. 97%	
		→ Lowering taxable income by \$9,700
Income Tax savings due to flow-through purchase (based on 46% marginal tax rate)	\$ 9,700 @ 46% = \$4,462	
Donor gives security directly to charity Donation tax credit from gift \$10,000 @ 46%	\$ 4,600	Tax credit
Capital gain	\$ 10,000	Proceeds of disposition
	<u>300</u>	Cost base of shares
	9,700	Capital gain
	4,850	Taxable portion of gain @ 50%
	2,250	Tax at 46 %
	(2,250)	Tax deferred
Net cost to donor	\$ 10,000	Purchase
	0	Capital Gains tax
	(4,462)	(Credit when purchased)
	<u>(4,600)</u>	(Tax credit from donation)
	<u>\$ 938</u>	

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The charity is not constrained by liquidity issues or valuation risk. The flow-through shares are sold immediately upon donation by the donor. As consideration for having arranged the series of transactions, the charities will pay a fee to the Corporation for its services as organizer and promoter of the gifting arrangement equal to a percentage of the donated flow-through security sold to the third party buyer.

There are two points you should keep in mind. First, you will only benefit from the budget change if you gift shares that have an accrued capital gain. If your shares have not appreciated in value since you purchased them or have even declined in value, you will not save any capital gains tax by donating them to a charity. You will, of course, still get a charitable donation receipt for the value of the shares but it would be no different than donating cash.

Also, you should only donate securities that you were otherwise going to sell. The tax on capital gains only applies when you sell your investment. Donating securities which you intend to hold long-term would only accelerate the payment of tax on the accrued gains on these investments.

How will the charity benefit from my gift?

We fully expect most charities to set themselves up to receive securities as gifts. Some charities may even actively pursue these gifts from donors. They will likely work with a brokerage firm to turn your gift into cash. Therefore, whether you give cash or securities, the charity will end up with the full amount of your donation to use in their programs.

Contact your Collins Barrow advisor if you have any questions on how to donate or the tax implications of donating flow through securities to your favourite charity.

Why Collins Barrow Ottawa LLP

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an independent member of
BAKER TILLY
INTERNATIONAL

Ottawa Office

301 Moodie Drive, Suite 400
Ottawa, Ontario K2H 9C4
T (613) 820-8010 F (613) 820-0465
ottawa@collinsbarrow.com

Manotick Office

1136 Clapp Lane
Manotick, Ontario K4M 1A3
T (613) 692-2553 F (613) 692-2995
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2725 Queensview Drive, Suite 500
Ottawa, Ontario K2B 0A1
T (613) 226-5661 F (613) 226-3141
queensview@collinsbarrow.com