

Planning Matters

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Understanding Proposed Changes to Taxation of Charitable Giving

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Background

Many Canadians contribute to philanthropic causes and registered charities and benefit from both tax deductions on the donation and, when transferred as a security (not cash), shielding of tax on capital gains embedded in that security. **This year the budget released by the Canadian Federal Government (the "Budget 2023")**

proposed changes to the Alternative Minimum Tax that could have a consequential impact on donations made by high-income individuals to registered charities in the future. The draft legislation to effect these changes was released on August 4, 2023 (the "Draft Legislation.") If enacted, these proposed changes could reduce the tax benefit of charitable giving for some donors, and

would apply to Canadian taxpayers in taxation years beginning after 2023.

What is the Alternative Minimum Tax (“AMT”)?

The AMT is an alternative method used to calculate the income tax individual taxpayers owe in Canada.

Each year individual taxpayers calculate their tax owing using the “normal” method, which takes into account preferential tax deductions and credits (such as the deduction for education expenses and dividend tax credits). For some filers, this result is then compared to the result from a second calculation where, in general, the individuals do not receive these preferential tax deductions and credits but their tax is calculated at a lower rate.

For most people, the first calculation will result in a higher tax bill and this is the tax they will pay for the year.

But, in incidences where the second calculation results in more tax payable:

- those taxpayers will pay the higher amount; and
- the difference between the lower amount of tax payable calculated using the normal method and the higher amount calculated using the second method is called the AMT.

<p>Tax owing from second calculation</p> <p>- <u>Tax owing from “normal” calculation</u></p> <p>Alternative Minimum Tax</p>
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While it may increase the amount owing in a given year, AMT can in fact be viewed as a sort of prepayment of tax. Generally, the amount of AMT can be used as a credit against regular tax payable for the next seven years, so long as the taxpayer pays sufficient income tax based on

the normal method of calculation in the year they wish to apply the credit. More on that below.

Example: Donating a security with an embedded capital gain

To illustrate how AMT works currently, consider an individual taxpayer, Ms. F, who has a substantial investment portfolio with a mix of personal investments and investments held by a wholly owned investment holding companyⁱ.

In 2022, Ms. F earned income from her investment portfolio of \$1,375,000. Using the normal method, Ms. F calculates her federal tax owing as approximately \$430,000. Using the second calculation, there is no AMT (i.e., it results in a lower potential tax bill). On this basis, Ms. F simply pays \$430,000.

But what happens if, in 2022, Ms. F wanted to make a large charitable donation? While she could have sold her publicly listed securities and donated the cash, the preferred method of donation would have been to donate the securities directly. If the donated securities had a fair market value of \$750,000 and cost base of \$250,000, then:

- Using the normal method, she would have incurred no capital gains tax on the embedded \$500,000 gain when donating the securities and she would have received a donation tax credit, which would have reduced her tax bill from \$430,000 to approximately \$183,000; and
- using the second calculation, Ms. F would have had no AMT owing.

Budget 2023 and Draft Legislation

Budget 2023 and the associated Draft Legislation proposes several changes which, if enacted, could result in AMT applying more broadly for taxation years that begin after 2023.ⁱⁱ

The proposed changes would generally increase the likelihood that the AMT will need to be paid by high-income individuals – especially those that claim significant tax credits such as donations that reduce their taxes payable and those that donate capital property, including publicly listed securities to a registered charity.

The changes proposed by the Draft Legislation contemplate, among other things, that:

- Most non-refundable tax credits (including the donation tax credit) will be limited to 50% of the tax credit available for regular tax purposes;
- The exemption for capital gains realized on the donation of capital property will be removed, resulting in 100%ⁱⁱⁱ of such gains being included in income for AMT purposes;^{iv}
- An exception is provided in respect of the capital gains realized on donations of publicly listed securities -- 30% (as opposed to 0% under the current regime) of such gains will be included in income for AMT purposes; and
- The minimum annual income for AMT to even be calculated will rise from \$40,000 to \$173,000.

Consider again Ms. F, who had no AMT owing on her donation of publicly listed securities with an embedded capital gain of \$500,000. If the Budget 2023 changes are enacted as contemplated and Ms. F made her donation after they came into force, then Ms. F would have AMT – additional tax – of approximately \$55,000.

As mentioned, however, this AMT is effectively a pre-payment that generates a carryover that can be applied as a deduction to reduce income tax owing based on the normal method for the next seven years. So, if you make future charitable donations, RRSP contributions, or have education or other credits, you could consider not deducting those and carrying them forward to use up the

AMT carryover before it expires, and then claiming those credits. Lastly, the available carryover in any given year is limited by any AMT owing in that year but can otherwise be applied to reduce or eliminate the tax payable (i.e., it cannot create a refund of taxes), so working closely with your tax advisor to plan properly is key.

On this basis, those individuals who are planning to make a charitable donation personally in the near future may wish to make the donation in the 2023 calendar year before any potential changes in the legislation become effective.

However, if this is not possible and the Draft Legislation is enacted, as written:

- Individuals should plan for increased AMT the year they make the donation, and how they will pay that increased tax, but noting they may still be able to recover this AMT over the next 7 years with advice from their tax advisor; and
- In addition, it is important to know that AMT applies to individuals, so taxpayers should also discuss with their advisors whether it makes sense to consider corporate rather than personal donations. Since corporate donations have the same benefit of a 0% inclusion rate on the capital gains realized on the donation of publicly listed securities, they encourage the continued support of registered charities and can have additional tax benefits.

Conclusion

Even if the changes to AMT proposed in the Draft Legislation are enacted as written, taxpayers can still continue to make impactful charitable donations to registered charities while maintaining tax efficiency. The best course of action for taxpayers considering large donations is to discuss these with their trusted tax advisors – whether or not these changes come to pass.

About the Contributors



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Endnotes

- i Please note that the example contemplates only the federal taxes. Provincial taxes would also need to be taken into account when considering your specific circumstances.
- ii Draft legislation was not provided with Budget 2023, so at this time it cannot be analyzed for the exact impact. The explanations and comments in this article are based strictly on the information contained in Budget 2023 on the assumption that the resulting legislation will be substantially the same.
- iii The inclusion rate for all capital gains is proposed to be increased from 80 percent to 100 percent.
- iv Subject to the 30% inclusion for publicly listed securities described below.

NOTE: The information contained herein should not be treated by readers as investment, tax, or legal advice and should not be relied on as such. You should consult legal or tax professionals regarding your specific situation.

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