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Be careful how you give to charity



VERN KRISHNA | December 5, 2012 8:25 AM ET
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A proper charitable donation to a proper charity may have a different impact on taxes.

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As we approach the end of the year, individuals will begin to consider the various methods of reducing their tax bills. Charitable gifting is an altruistic and noble method of reducing taxes, but only if done properly and with true donative intent.

The essentials of charitable giving require: a valid gift to a legitimate, registered charity; a proper valuation of all underlying transactions; and appropriate legal opinions.

To understand how charitable donations work for taxpayers, we first need to appreciate the nuanced difference between tax deductions and tax credits.

The difference between a deduction and a credit is that a deduction reduces income, which indirectly reduces tax payable, whereas a credit directly reduces the amount of tax payable without reducing income. Ultimately, however, both deductions and credits put money in the taxpayer's pocket, but they affect individuals differently depending upon their marginal tax rates.

The table shows how a dollar of tax credit is worth more to a taxpayer than the same dollar deduction from income. The reason for this is that a deduction is only worth its face value multiplied by the taxpayer's marginal rate of tax. Hence, a \$100 deduction to an individual with a marginal rate of 50% is worth \$50 tax savings; at a marginal rate of 25%, the saving is only \$25. The value of a deduction increases as the marginal rate rises, which means that higher-income taxpayers get a larger tax saving. Put another way, those who pay taxes at a higher rate save more from a deduction than those who pay taxes at lower rates.

DEDUCTION VS. TAX CREDIT

Assume an individual with a marginal tax rate of 50% earns \$100,000. The following example compares a \$20,000 deduction with a \$20,000 tax credit.

	Deduction from income	Tax credit
Income	\$100,000	\$100,000
Less: deduction	(\$20,000)	-
Taxable income	\$80,000	\$100,000
Tax at 50%	\$40,000	\$50,000
Tax credit	-	(\$20,000)
Net payable	\$40,000	\$30,000

SOURCE: VERN KRISHNA / BORDEN LADNER GERVAIS LLP

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In contrast, the value of a tax credit remains constant through all marginal tax rates, which means that all individuals get the same benefit, regardless of how much they pay in taxes. This distinction is important in determining the distributional effect of taxes.

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With one notable exception, the Income Tax Act reduces the value of federal non-refundable credits to the deduction equivalent of the lowest marginal tax rate of 15%. So, for example, for an individual with \$42,000 taxable income, a \$1,000 deduction becomes a \$150 tax credit. The rate is neutral between deductions and credits and the taxpayer is indifferent to which one he gets.

But there is a great difference between the value of a deduction and a credit for higher-income taxpayers. For an individual with taxable income of \$150,000, a deduction of \$1,000 would normally reduce tax payable by \$290 at a marginal rate of 29%. The Act, however, reduces the value of the deduction to a \$150 credit. The conversion of deductions to credits in 1987 was part of tax “reform” to increase the effective rate of tax on higher-income taxpayers.

Charitable donation credits are an important exception to the rule. To encourage philanthropy, the statute converts all charitable donations (above \$200) to credits at the highest marginal rate of tax. For example, the credit equivalent of a \$100,000 donation would be approximately \$29,000 at a marginal rate of 29%. Thus, donation credits are incentive provisions designed to support worthwhile causes.

The attractiveness of the donation credit has also attracted a plethora of dubious gifting programs. In these schemes, promoters set up arrangements that appear, through a maze of structures (usually offshore) and valuation gymnastics, to confer greater benefits on so-called “charitable causes” than the donor’s actual cash contribution. Hence, for example, an individual donating \$2,500 to one of these arrangements might end up with a charitable receipt for \$15,000, which would be worth a federal tax credit of \$4,350. With the provincial credit added, the total tax savings would be approximately \$6,900. That is equivalent to a guaranteed immediate cash rate of return of 176%, which is quite attractive in these market conditions.

Understandably, the Canada Revenue Agency has the entire charitable sector under a microscope for potentially abusive schemes. As we approach the end of the year, individuals will be approached by charities for year-end donations that promise generous tax credits. Taxpayers should ensure they are donating to legitimate charities and not just buying credits under the guise of “gifting” to fly-by-night offshore schemes.

Taxpayers who do not comply with the rules risk losing their entire deduction, including their actual cash outlay, and being assessed penalties and interest. The key to giving is that the gift must have at least an element of altruism. Otherwise, the good can turn into the bad and become ugly for all.