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In this article Vern Krishna discusses charitable gifting which is an altruistic and noble method of reducing taxes, but only if done properly and with true donative intent. The essentials of charitable giving are a valid gift to a legitimate registered charity, a proper valuation of all underlying transactions and appropriate legal opinions.

CRA Keeping Close Eye On Abusive Schemes

Date: January 31, 2013

CRA keeping close eye on abusive schemes

Vern Krishna

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 are a valid gift to a legitimate registered charity, a proper valuation of all underlying transactions and appropriate legal opinions.

Accountants giving tax advice here must be careful.

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.

Let's use the example of a taxpayer who earns $100,000. With a $20,000 deduction, the taxable income is $80,000. Taxed at 50 per cent, the net payable is $40,000. When the same income is taxed at the same rate and then a $20,000 tax credit is applied instead, the net payable is $30,000.

This example illustrates that a dollar of tax credit is worth more to a taxpayer than an equivalent 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 per cent is worth a $50 tax savings; at a marginal rate of 25 per cent, 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.

Stated another way, those who pay taxes at a higher rate save more from a deduction than those who pay taxes at lower rates.

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.

With one notable exception, the *Income Tax Act* reduces the value of federal non-refundable credits down to the deduction equivalent of the lowest marginal tax rate of 15 per cent. Hence, 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.

There is, however, a great difference between the value of a deduction and a credit for higher income taxpayers. For example, 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 percent. 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 $29,000 at a marginal rate of 29 per cent. 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 through a maze of structures (usually offshore) and valuation gymnastics appear to confer greater benefits on so-called “charitable causes” than the donor’s actual cash contribution. 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 $6,900. That is equivalent to a guaranteed immediate cash rate of return of 176 per cent, which is quite attractive in these market conditions.

Understandably, the Canada Revenue Agency has the entire charitable sector under a microscope for potential 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 that 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 CRA is also pursuing professional advisors who lend their names to such arrangements with civil and possible criminal sanctions. 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.

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