CREATE A LASTING LEGACY WITH TAX SMART GIVING

As human beings we all have a deep desire to leave a life print or legacy. For some of us it means raising responsible children who make us proud and contribute to society and for some of us it means supporting the people, causes and organizations that we deeply care about, with a bequest in our will.

One of the best quotes I have heard that distills the essence of our desire to leave a legacy, is a quote from Ernest Becker in his Pulitzer award winning book, the denial of death, which was published in 1973 and was awarded the Pulitzer prize for general non-fiction in 1974, two months after the author's death. In that book, Becker says "What man really fears is not so much extinction…but extinction with insignificance."

Our tax system is designed to give donors to charities incentives to donate more and there are many strategies that Canadians can use to multiply their current giving as well as their bequests to charities.

Taxes play a big role in the return on our investments in Canada. We pay income tax and we pay tax on our investments, in addition of course to paying an array of other taxes on a municipal and provincial level.

Perhaps the best way to show the impact of taxes on our investments is thinking of three separate asset classes. If you think of all that you own fitting in a bucket, there are three types of assets. The first type is like a leak-proof bucket. These are assets that are not taxed at all. Unfortunately, there are not very many of them available in Canada and there are only three types of assets that fit this category.

The first leak-proof asset is lottery winnings. As you can imagine, this is an asset that not very many Canadians ever get to enjoy. Lottery winnings are completely tax free in Canada, whereas in the US they are fully taxed as income.

The second type of leak-proof asset is a Tax-Free Savings Account (TFSA). These types of accounts were introduced in 2009 and if you have not set one up yet you can contribute a maximum of $52,000 to a TFSA in 2017 and you can add $5,500 per year going forward. Assets held in a TFSA will grow tax sheltered and can be withdrawn free of tax any time.

The third type of leak-proof asset is our principal residence. Fortunately, many Canadians have taken advantage of tax free growth of this asset and over the last decade it has been a huge contributor to the wealth of Canadians who live in major urban centers like Toronto and Vancouver. This asset grows free of tax and no taxes are realized when you sell your principal residence or when it is transferred at death.

The second type of assets are similar to a leaky bucket, so let's call them leaky assets. These are assets where 50% of the capital gains is taxed as income. These assets include appreciated securities, such as stocks, bonds or mutual funds, as well as investment properties. Any gain realized upon the sale of these assets or upon transferring them to a third party or on death are treated as capital gains income and 50% of the gain has to be included in the income of the owner in the year of sale, transfer or on death and will be taxed based on his/her top marginal tax bracket.

The third type of assets are like an extremely leaky bucket so let's call them the extremely leaky assets. The return on these assets is treated as regular income and 100% of the income that they generate is taxed each year based on the highest marginal tax bracket of the owner. These assets include GICs, bonds, private mortgages, and withdrawals from RRSPs and RRIFs.

As Canadians we save for our retirement in many different ways, using different investment and savings vehicles. However, when it comes to transfer of wealth on death, RRSPs and RRIFs are like a ticking time bomb. The reason is that while upon death of the first spouse, no taxes are realized and RRSP and RRIF assets are transferred to the surviving spouse, on the death of the second spouse (of for people who are single), the entire balance of RRSP and RRIF accounts is added to the income of the deceased and taxes and will be taxed as income based on the deceased's highest marginal tax bracket.

For example, if you have accumulated $500,000 in your RRSP or RRIF and you are the last spouse to die, assuming you had no other income in the year of death, if you live in Ontario, $231,000 of taxes would apply to your RRSP or RRIF balance, leaving only $269,000 for your heirs. On the other hand, if your income from other sources in the year of death happened to be over $220,000, then 53.53% of the balance of your RRSP or RRIF account would be subject to tax leaving less than half the amount for your beneficiaries.

RRSPs and RRIFs are not the only assets that get eroded when passing from one generation to another. According to the Business Families Centre at Sauder School of Business, "almost one third of family business leaders will retire in the next five years. However, only 32% of these business families have a succession plan. Research and experience shows that most succession plans fail to integrate strategies that address the human and social wealth of a family together with its financial assets. Over 70% of family owned business do not survive to the next generation."

Most of us want to leave our assets to our loved ones when we die. For many philanthropic Canadians this includes the charities that they love and support during their lifetimes. However, after the erosion that most estates suffer due to taxes and after leaving money for children and family, charity usually ends up being at the end of the line.

However, there are financial strategies available to all Canadians that allow you to pass on family wealth to your beneficiaries without paying taxes, to sell appreciated assets and pay no capital gains taxes, to avoid capital gains taxes while receiving an additional tax deduction from the CRA, and to support the causes that you care about without reducing your own lifestyle or the inheritance of your beneficiaries.

One of these strategies, is the 50/50 strategy that applies to leaky assets where 50% of the capital gains is taxed as income.

Let's look at an example to illustrate this strategy. David and Mary are a newly retired couple. David is 60 and Mary is 58. They are interested in having a guaranteed income for life, leaving an inheritance for their children and grand children and converting their taxes to charitable donations.

They own some appreciated stocks that they had bought decades ago and have a market value of $100,000 and a cost base of $20,000. Therefore, they have an $80,000 capital gain, that will be realized should they sell these stocks. Half of this gain or $40,000 will be included in their income and since they are in a 50% marginal tax bracket, they would have to pay $20,000 in capital gains taxes. Therefore, like many Canadians they have locked up capital in their portfolio and have avoided selling these stocks for fear of triggering the capital gains tax liability.

The 50/50 strategy would help them avoid capital gains tax, create tax credits, create an income they cannot outlive and give to their favourite charity. To implement this strategy, they would sell 50% of the stocks and keep the proceeds and donate the other 50% in kind to charity and by doing this they could eliminate 100% of the taxes.

The key here is to donate the stocks to charity in kind. If you donate stocks to a registered charity in kind, then all the capital gains on those stocks will be eliminated and will not be subject to tax and you will receive the same charitable donation tax credit that you would receive had you sold the stocks and donated the cash proceeds to charity.

As mentioned before, David and Mary have a capital gains tax liability of $80,000 on their $100,000 stock portfolio that will result in a $20,000 tax bill if they sell the stocks (($100,000 - $20,000) x .5 (50% capital gains tax inclusion rate) x .5 (50% marginal tax bracket)).

If they donate 50% of their stocks in kind to charity, the $50,000 donation will create a charitable donation tax credit of approximately $25,000.

If they sell the other 50% of their stock portfolio or $50,000, they will be left with $40,000 after tax (the capital gains tax liability on the entire stock portfolio was $20,000 so the tax liability on half the portfolio is $10,000).

Now if they take the $25,000 tax savings and the $40,000 after tax proceeds of selling half of their portfolio, they can use this $65,000 and purchase a joint last-to-die life annuity that would pay a guaranteed income of $3,000 per year*.

While David and Mary love receiving a guaranteed income for life, they don’t like the fact that after they both die, their children will be left with nothing and the life insurance company will keep whatever is left of the capital they used to buy the life annuity.

To avoid this outcome, they keep $1500 of the guaranteed income for themselves to enhance their cash flow and use the other $1500 to buy a joint last-to-die life insurance policy with a death benefit of $100,000.*

The result is that under the scenario of plainly selling the stocks they would have ended up with a tax bill of $20,000 and net proceeds of $80,000, while generating no guaranteed income or donation to charity. However, by using the 50/50 strategy, they end up paying no tax, they will have a guaranteed income of $1500 per year, they will donate $50,000 to their favourite charity and on death of the last spouse, their children will inherit $100,000 tax free.

Therefore, by using the 50/50 strategy they would be able to achieve their goals of avoiding capital gains tax, creating tax credits, creating an income they cannot outlive and giving to their favourite charity.

There are many other strategies that can help you save taxes and make a meaningful donation or leave a bequest to your favourite charities without reducing the inheritance of your beneficiaries or your own lifestyle in retirement. By consulting a financial advisor who specializes in charitable tax planning you can find out which strategies would be the best fit for you.

* Annuity Quote January 2017: BMO Insurance. Life Insurance Quote January 2017: Canada Life

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