New rules require foundations to get rid of excess shareholdings

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By Theresa Man

The Department of Finance recently released the long-awaited technical amendments to the *Income Tax Act* (Canada) to implement the remaining tax measures contained in the March 19 federal budget.

Among these remaining tax measures is the proposed new excess business holding rules (EBHR) which will have a substantial impact on tax planning for private foundations and their donors. The new EBHR require private foundations to divest themselves of excessive public and private shareholdings beyond the limits permitted by the new rules, and to disclose material corporate shareholdings in the foundations' annual information return.

A private foundation that holds an "insignificant interest" (i.e. two per cent or less) in respect of a class of shares of a corporation will not be subject to the divestiture or the public disclosure requirements under the EBHR.

If the total shareholdings of a private foundation and "relevant persons" in respect of the private foundation who hold a material interest in a class of shares is over two per cent of all outstanding shares of that class, the private foundation will be required to disclose in its annual information return the name of the corporation, the foundation's holdings of that class of shares, and the total shareholdings the related persons of that class of shares.

In addition, "material transactions" of a private foundation and its relevant persons are also required to be disclosed. A "material transaction" means a share transaction or a series of transactions involving more than $100,000 or 0.5 per cent of a class of shares. A "relevant person" is generally a person who does not deal at arm's length with any person who controls the private foundation, or with any member of a non-arm's length group of persons that controls the foundation.

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The existing rules of s. 251 of the Act, which determine when a corporation is related to another person, will apply as if the foundation were a corporation. However, a "relevant person" does not include an estranged family member. For example, an individual who is at least 18 years old, living separate and apart from the controlling person or member of the controlling group, and whom the minister, on review of an application by the foundation, has agreed is dealing at arm's length with the controlling person or member of the controlling group, would not be a "relevant person."

If the total corporate shareholdings of a private foundation and its relevant persons exceeds 20 per cent, the foundation will be required to divest itself of the shares over the 20 per cent threshold within certain time periods required by the EBHR, depending on how the excess arose.

For example, if the excess arose as a result of the private foundation acquiring shares for consideration, the excess must be divested within the same year; and if the excess arose as a result of a donation by way of a bequest, the excess must be divested within five years. Under certain conditions, the minister may defer a divestment obligation by up to five years upon application by the foundation, such as a large donation of shares involving complex corporate structures.

The EBHR exempt certain shares from divestiture. A private foundation will not be required to divest shares donated before March 19, 2007, if the donation was made subject to a trust or direction that the foundation may not dispose of them.

This exemption also applies to donations made on or after March 19, 2007, and before March 19, 2012, pursuant to the terms of a will signed before March 19, 2007, that has not been amended. It also applies to donations made after March 19, 2007, under the terms of a testamentary or *inter vivos* trust created before March 19, 2007, and not amended after that date.

The EBHR provides transitional rules for private foundations with total corporate holdings exceeding the 20 per cent threshold on March 18, 2007. These foundations will have up to 20 years to divest the excess, provided that they divest at least 20 per cent of the excess every five years.

In order to encourage private foundations to divest their excess as soon as possible, donations of publicly listed shares to a private foundation that has not divested all excess by March 18, 2012, will be subject to capital gains tax resulting from the disposition and will not enjoy the capital gains tax exemption proposed by the 2007 federal budget.

A penalty tax may be imposed on a foundation that has not divested its excess shareholdings as required or that fails to comply with the disclosure requirements. Repeated or uncorrected infractions of the EBHR may result in the revocation of the foundation's charitable status.

The application of these proposed rules is complicated and unclear in many respects. Private foundations, their donors and advisers should become familiar with the EBHR to ensure compliance. Where appropriate, private foundations may want to apply to be redesignated as either public foundations or charitable organizations.

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Avoid overly broad questions when seeking court's opinion

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the costs incurred in the course of the litigation.

Unfortunately, the law is not so clear in Canada, and in fact, varies widely from province to province. In Ontario, courts are more willing to provide a greater amount of direction regarding prospective litigation. In contrast, courts in Manitoba, Alberta and P.E.I. seem less willing to do so.

The courts' key concern is that they do not want to prospectively provide advice to trustees regarding litigation decisions where they may be called upon in the future to examine the propriety of the trustee's decision or to decide the litigation itself.

Therefore, when seeking direction from the court, trustees should avoid asking the court overly broad questions or to determine the merits of the case itself. However, in particularly difficult situations, it would be prudent for trustees to seek the court's opinion on a chosen set of actions or to clear up any misunderstandings regarding the purpose of the litigation.

All of the above is generally moot if a trustee is ultimately successful in litigation. However, given that "successful" is often in the eye of the beholder, particularly on a settlement, trustees are advised to be reasonable and ensure that all litigation expenses are properly incurred, critically analyse the merits of the case and apply to the court for direction should any questions arise.

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