Tax Shelters and Charitable Donations – a Miss-Match

A Paper

By

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Abstract

Both the Department of Finance and Canada Revenue Agency have been attempting to shut down tax shelter donation arrangements, including buy-low donate-high arrangements, leveraged cash donations, and gifting trust arrangements with various amendments to the *Income Tax Act* (Canada) since 2003, and reassessing taxpayers involved with such donation tax shelters. This paper makes the case that these donation tax shelters should be shut down because there is no justification to support tax concessions that exceed the value of the donations being given to taxpayers, whether it is gifts-in-kind or cash gifts, and resulting in a net economic benefit to the taxpayer. This paper reviews the status of draft legislative amendments made to curtail these tax shelter arrangements, the consequences of non-compliance with the proposed changes, and their impact on those involved in donation tax shelters, including taxpayers, promoters, advisors, appraisers, and charities. This paper also reviews the various steps taken by Canada Revenue Agency to shut down abusive donation tax shelters schemes and their effectiveness.

A. Introduction

On November 22, 2005, Canada Revenue Agency ("CRA") issued a *Taxpayer Alert*[1] to remind investors to be aware of the risks associated with participating in tax shelter donation arrangements, including buy-low donate-high arrangements, leveraged cash donations, and gifting trust arrangements. This is the most recent alert issued by CRA, warning taxpayers to use caution when involved with these types of donation tax shelters, which often promise taxpayers attractive tax benefits with little or minimal cash outlay by the taxpayers themselves.

Both the Department of Finance ("Finance") and CRA have been attempting to shut down these donation tax shelters with various amendments to the *Income Tax Act* (Canada)[2] since 2003, and reassessing taxpayers involved with donation tax shelters. This paper reviews the rationale of shutting down these donation tax shelters and how effective the attempts by Finance and CRA have been in doing so. This paper also reviews the impact of these proposed amendments on those involved in donation tax shelters, including taxpayers, promoters, advisors, appraisers, and charities.

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[1] Canada Revenue Agency, *Taxpayer Alert,* November 22, 2005.

[2] R.S.C. 1985, c. 1 (5th Supp.), as amended (hereinafter referred to as the "Act").

B. Donation Tax Shelters – The Basis

In general, tax shelters are arrangements that permit an investor to claim a tax deduction equal to a portion or even the entire amount of the investment within in a short time period to create a loss in the current period from that particular source of income, and able to reduce, therefore "shelter," income taxes payable from other sources of income.[3] Originally, tax shelters usually involved investments in aircraft, movies, scientific research, resource exploration and development, and computer software. As the ability to claim tax benefits from these tax shelter arrangements reduce over the years due to changes to the Act, tax shelters gradually evolved to involve charitable donations of gifts-in-kind and leveraged charitable donations. Early donation arrangements involve donation of artwork. Later, promoters also involved donation of other property, such as comic books, figurines, plates, stamps, jewellery, medical supplies, computer programs, educational products, food (such as rice, beans, barley grass) clothing and pharmaceutical products.[4]

A typical tax shelter involving donations of gifts-in-kind would involve a taxpayer purchasing property for a low price, donating the property to a charity, usually pre-arranged by the promoter, and receiving a donation tax receipt from the charity in an amount purported to be the fair market value of the donated property that is substantially greater than the price paid by the taxpayer. The fair market value of the donated property is usually supported by an independent appraisal, also arranged by the promoter or vendor of the property. Often, the taxpayers never took possession of the donated property, which is directly transferred or delivered to the charity. The attractiveness of these types of "buy-low donate-high" tax shelters to taxpayers lies in the fact that the tax credit based on the high value of the receipt far exceeds the total of the taxpayer's cost in purchasing the donated property and any tax payable on any gain realised in the disposition of the donated property, resulting in a net "profit" to the taxpayer.

Another variation would involve gifting trust arrangements, which would typically involve a taxpayer who is inclined to charitable giving becoming a beneficiary of a Canadian

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[3] "Policy Forum: A Comment on Valuing In-Kind Charitable Gifts on Property and Leveraged Charitable Donations" (2003), vol. 51, no. 6 Canadian Tax Journal, 2191-2192 at 2191. For a review of the various earlier tax shelters, see Dino S. Infanti, CA, "Tax Flavoured Investments – What do Investors Need to Know?," paper presented at the 2002 British Columbia Tax Conference (Vancouver: Canadian Tax Foundation, 2002), 8:1-22; and Ron Voyer, CA, "Tax Shelters," paper presented at the 1999 British Columbia Tax Conference (Vancouver: Canadian Tax Foundation, 1999), 17:1-12.

[4] For a summary of the various types of donation tax shelter schemes, see Daniel Sandler and Tim Edgar, "The Tax Expenditure Program for Charitable Giving: Kicking a Gift Horse in the Teeth" (2003), vol. 51, no. 6 *Canadian Tax Journal*, 2193-2214, at 2197, 2203-2205. See also Graham Turner, "Tax Shelters — Past, Present and Future" *Tax Topics*, Number 1654 (Toronto: CCH Canadian, November 20, 2003), 1-5; and Robert Kepes, "Charitable Donation Tax Shelter: Legitimate Tax Planning or Tax Porn?" *Tax Topics* no. 1660 (Toronto: CCH Canadian, January 2, 2004), 1-6.

resident trust established by a non-resident settlor, the trust distributing property to the taxpayer, who would donate the property distributed together with some cash to a pre-arranged charity. The taxpayer's adjusted cost base of the property would be equal to the trust's cost, which is fair market value, if the trust received the property in the first place as a gift. Therefore, the donor would have no capital gain on the donated property, maximising the tax benefit the donor received.[5]

A third type of donation tax shelter are "leveraged charitable donation arrangements," typically involving a taxpayer borrowing a substantial portion of a cash donation made to a charity in return for a charitable donation receipt for the cumulative amount donated. In order for the arrangement to be attractive to taxpayers, the promoter usually arranges for the taxpayer to enter into some form of insurance policy and/or investment for a return that would, over the term of the loan, be sufficient to pay off the loan borrowed, so that the tax credit that results from the cash donation would exceed the economic cost of the cash donation to the charity, therefore, also, resulting in a net "profit" to the taxpayer.[6]

C. Rationale for Shutting Down Donation Tax Shelters

A donor who makes a gift to a registered charity would entitle the donor to a tax credit in the case of an individual,[7] or a tax deduction in the case of a corporation.[8] At the tax policy level, the "profitable" nature of the donation tax shelters indicates that it is fundamentally flawed for taxpayers to be able to "cash in" on the government's tax relief provided for charitable gifts.

A critical review of the justification of the deductibility or tax treatment of charitable donations is outside the scope of this paper.[9] In brief, it has been pointed out that the possible justifications for the donation support include:

> (1) A deduction/credit is required as a proper or equitable measure of the income tax base because (a) giving to charity is a moral obligation; (b)

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[5] Turner, *supra* note 4, at 4.

[6] Sandler and Edgar, *supra* note 4 , at 2197.

[7] The credit for individuals is set out in section 118.1 of the Act. In general, individuals are entitled to a tax credit of 16% on the first $200 of donation, and 29% of gifts over $200, up to 75% of net income, plus 25% of certain taxable capital gains, 25% of any capital cost recapture.

[8] The credit for corporations is set out in section 110.1 of the Act. In general, corporations are entitled to a tax deduction from taxable income, up to a maximum of 75% of net income, plus 25% of certain taxable capital gains, 25% of any capital cost recapture.

[9] For example, see David G. Duff, "Tax Treatment of Charitable Contributions in Canada: Theory, Practice, and Reform" (2004) 42 Osgoode Hall L.J. 47; David G. Duff, "Charitable Contributions and the Personal Income Tax: Evaluating the Canadian Credit," in *Between State and Market*: *Essays on Charities Law and Policy in Canada,* Jim Phillips, Bruce Chapman, and David Stevens, eds. (Montreal: McGill-Queen's University Press, 2001) at 407-56; Neil Brooks, "The Tax Credit for Charitable Contributions: Giving Credit Where None Is Due," in Phillips, *supra* at 457-81.

> the income due to the donation should be taxed, if at all, in the hands of the ultimate recipient; and/or (c) the availability of the deduction maintains tax equity between donors of income on the one hand and donors of services and capital on the other.
> (2) Charities are generally useful and ought to be rewarded or encouraged by making a deduction/credit available to people who support them.
> (3) Tax-supported charity promotes pluralism in the production of public goods and therefore a deduction/credit ought to be available to people who support them."[10]

Regardless of what the justification for the tax relief is, tax relief *lowers* the costs of charitable giving to taxpayers, while the government provides a matching program to charities in an amount equal to the tax foregone by the government from the donation made by taxpayers.[11] However, none of the justifications for the tax relief would support tax concessions be given to taxpayers that exceed the value of the donations, whether it is gifts-in-kind or cash gifts, made by the taxpayer and resulting in a net *economic benefit* to the taxpayer. In other words, the government becomes the sole contributor to the charity involved, in addition to providing a benefit to the taxpayer. If so, it would have been better off for the government to undertake the charitable work itself or to fund the charity directly, without the need to provide the added layer of economic benefit to the taxpayer as a middle person.

In addition, the fact that the donor is actually receiving a net economic benefit from having made the donation is inconsistent with the requirement that a valid gift must involve the donor being improvised.[12] The Act does not contain a definition of "gift." Therefore, courts apply the common law or civil law definition of the term. A gift at common law requires three elements, namely an intention to donate, acceptance of the gift and a sufficient act of delivery.[13] The court in *Friedberg v. The Queen* defined a gift to be "a voluntary transfer of property owned by a donor to a donee, in return for which no benefit or consideration flows to the donor."[14] This definition is adopted by CRA.[15] Recent proposed amendments to the Act would to allow a donor to receive

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[10] David P. Stevens, "Update on Charity Taxation," in *Report of Proceedings of Fifty-Third Tax Conference*, 2001 Tax Conference (Toronto: Canadian Tax Foundation, 2002), 28:1-41, summarizing arguments reviewed by Duff, *supra* note 9.

[11] Sandler and Edgar, *supra* note 4 , at 2194.

[12] Rob DePetris, "Stopping Perceived Abusive Charitable Tax Schemes and Much More," *2004 Ontario Tax Conference*, (Toronto: Canadian Tax Foundation, 2004), 5B:1-17, at 5B:4.

[13] Timothy G. Youdan, "Charitable Gifts and Pledges: Some General Comments," paper presented at the Seventh Annual Estates and Trusts Law Summit, Law Society of Upper Canada, December 1 and 2, 2004.

[14] 89 DTC 5115; [1989] 1 CTC 274 (FCTD), var'd. 92 DTC 6031 at 6032; [1992] 1 CTC 1 (FCA).

[15] Canada Revenue Agency, *Interpretation Bulletin* IT-110R3, "Gifts and Official Donation Receipts," June 20, 1997. It defines a "gift" to be a voluntary transfer of property without valuable consideration. Generally a gift is made if all three of the conditions listed below are satisfied: (a) some property—usually cash—is transferred by a donor to a registered charity; (b) the transfer is voluntary; and (c) the transfer is made without expectation of return. No benefit of any kind may be provided to the donor or to anyone designated by the donor, except where the benefit is of nominal value.

a donation tax receipt even in situations where the donor or someone else receives a limited advantage as a result of the gift. This is referred to as "split-receipting."[16] The split-receipting rules were part of a package of proposed amendments to the Act first introduced by Finance on December 20, 2002. These amendments have since undergone various incarnations on December 5, 2003 and February 27, 2004, with the latest consolidation and amendment of the proposed regime coming with legislative amendments proposed by Finance on July 18, 2005.[17] The explanatory notes accompanying the July 2005 amendments explain that "a transfer of property is not a gift unless the donor is impoverished by the transfer to the benefit of the donee and it is the donor's intention to enrich the donee without consideration," and that the proposed amendments "are intended to reflect the policy that the amount eligible for an income tax benefit to a donor, by way of a charitable donation deduction or credit or a political contributions tax credit, should reflect the economic impact on the donor (before considering the income tax benefit) of the gift or contribution."[18] Where the tax credit received by taxpayers involved in donation tax shelters exceeds the amount of cash paid by the donor to acquire the donated property or cash donated to the charity in a leveraged donation arrangement, it is doubtful whether a gift was actually made. Specifically, the explanatory notes indicate as follows:

> It is generally accepted that the tax benefit available to a taxpayer, by way of a charitable donation deduction or credit, is not considered an advantage or benefit that would reflect a lack of donative intent on the part of a taxpayer. However, there may be circumstances where the intention of a taxpayer to make a gift is in doubt because of the combination of tax and other benefits to the taxpayer. If the primary motivation of a taxpayer for entering into a transaction or series of transactions is to return a profit to the taxpayer by way of a combination of tax and other benefits, the taxpayer may not be impoverished by the transfer of a property to a charity. Subsection 248(30) is not intended to allow a taxpayer to profit by the making of a gift.[19]

In a speech given by Carl Juneau, the then Director of Policy, Planning and Legislation Division of the Charities of Directors of CRA, on November 12, 2003, at the *Church & the Law™ Seminar* hosted by Carter & Associates, he noted that tax shelter donation schemes can mean a significant fiscal loss to the Canadian government. Juneau advised that "…the bottom line is that these schemes are contrary to the spirit of giving and to charity. Charities should be in the spirit of, [the] business of generosity, not in the business of making money for others... If you

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[16] For an explanation, see Theresa L.M. Man, "July 18, 2005 Draft Amendments to the Income Tax Act Affecting Charities: Part I – Definition of Gift & Split-Receipting," *Charity Law Bulletin* No. 76, September 8, 2005; and M.E. Hoffstein, Theresa L. M. Man and Laura E. West, "When is an Advantage Not an Advantage—Issues Arising from the Proposed Split Receipting Regime," paper presented to the Canadian Bar Association/Ontario Bar Association 4th National Symposium on Charity Law, May 11, 2006 (online: www.charitylaw.ca).
[17] Canada, Department of Finance, *Legislative Proposals Relating to Income Tax*, July 18, 2005.
[18] Explanatory notes for the proposed subsections 248(30) to (41) contained in the 2005 July amendments.
[19] Explanatory notes for the proposed subsection 248(30) contained in the 2005 July amendments.

have been approached by some of these promoters, be very careful. The tax avoidance section is keeping close tabs on these promotions, and there will be legislative amendments to shut down this kind of practice." The Canadian Association of Gift Planners, which represents approximately 1,200 gift planners in Canada, applauded CRA's position on donation tax shelters. Its chair of government relations, Malcolm Burrows, indicated that "[t]hese so-called gifts do not make children healthier, save wildlife habitat, or put food in the mouths of the homeless… These arrangements are tax and profit motivated. A charitable gift by contrast has a cost to the donor. The promoters of these arrangements have no interest in helping charities achieve their charitable mission."[20]

Due to the above reasons, Finance proposed a series of amendments to the Act between 2003 and 2005 to shut down abusive tax shelters involving donations to registered charities resulting in the donor receiving a net economic benefit. These changes have not yet been enacted into law. At the same time, CRA is taking active steps to curtail these abusive tax shelters.

D. Legislative Proposals to Shut Down Donation Tax Shelters

1. The 2000 federal budget

In the 1990s and up to February 27, 2000, promoters purchased artwork at discount prices either from artists or in a distress sale, and sold them to taxpayers who in turn donated the artwork to charities. These transactions are often known as "art flip planning." Subsection 46(1) of the Act contains a *de minimus* rule which deems the cost and proceeds of sale of personal-use property (i.e. property for the personal use and enjoyment of the taxpayer[21]) to be a maximum of $1,000, so that if such property is sold for $1,000 or less, there will not be any gain or loss for the taxpayer, and therefore no tax consequences.[22] To take advantage of this provision, promoters structured the donation so that the "fair market value" of the artwork donated would not exceed $1,000. This would allow the taxpayer/donor to take full use of the $1,000 donation receipt issued by the charity, without any need to offset any gain realized on the donated artwork.

In order to curtail these types of abuse, the 2000 federal budget released on February 28, 2000 introduced an amendment to subsection 46(1) to exclude the application of the *de minimus* rule to "excluded property," which was a new term defined in subsection 46(5) to mean "property acquired by the taxpayer, or by a person with whom the taxpayer does not deal at arm's length, in circumstances in which it is reasonable to conclude that the acquisition of the

[20] Paul Waldie, "Tax shelters being abused, charities say," *Globe and Mail*, December 1, 2003.
[21] Section 54 of the Act.
[22] Section 54 also indicates that art work, jewellery, rare folio/manuscript/book, stamp and coin are "listed personal property" that is a special type of personal-use property that usually appreciate (rather than depreciate) in value over time.

property relates to an arrangement, plan or scheme that is promoted by another person or partnership and under which it is reasonable to conclude that the property will be" donated to a charity. These changes apply to property acquired after February 27, 2000.

With this amendment, it would still be open for CRA to challenge the accuracy of the fair market value of the donated artwork.[23]

2. The 2003 federal budget

Prior to February 2003, the definition of "tax shelter" in subsection 237.1(1) of the Act applied to arrangements promoted as providing deductions in computing income or taxable income, it did not apply to those that are promoted as providing only the deduction of tax credits. The 2003 federal budget eliminated this technical distinction so that promoters are now required to register a property as a tax shelter if representations are made that a potential purchaser will be able to claim, within four years, any combination of deductions in computing income or taxable income and federal tax credits which in total equal or exceed the purchaser's net cost of the property. The definition of tax shelter is now amended to clarify its application to property acquired under a "gifting arrangement"[24] in respect of which it is represented that a donation or contribution of the property would generate tax credits or deductions (such as charitable donations tax credits or deductions) equal to or exceeding the net cost of the property to the donor.[25] Further, a gifting arrangement also involves a transfer of property in respect of which it is represented that a donation or contribution of the property would generate tax credits or deductions, if it may reasonably be considered that a person will incur limited-recourse debt in connection with the arrangement.[26] The definition of "gifting arrangement" is intended to be broadly encompassing and would "not be limited to situations where a donor acquires property under an agreement and, under the same agreement, the property acquired is to be gifted to a

[23] In CRA document number 9707235, dated November 13, 1997, CRA was requested to provide an advance tax ruling on the donation of wildlife art to a registered charity at a value in excess of the amount paid to purchase the artwork. CRA indicated that it declined to provide any comment in so far as the concerns involved the determination of fair market value because it is CRA's position that "tax savings depends on a sudden increase in FMV at [the] time of making [the] gift as compared to the actual costs a short time earlier" and "it is also a determination of fact as to whether the disposition is an adventure in the nature of trade or a capital disposition."

[24] "Gifting arrangement" is defined in subsection 237.1(1) of the Act.

[25] In order to avoid a double counting of tax credits in the formula used to determine if a property or an arrangement is a tax shelter, it is proposed that the definition of "prescribed benefits" in *Income Tax Regulations* 231(6)(*b*) be amended to exclude any federal tax credit already taken into account in determining whether tax credits and deductions exceed net cost. Provincial tax credits would continue to be considered prescribed benefits.

[26] Canada, Department of Finance, 2003 Budget, Budget Plan, February 18, 2003, at 339-440.

registered charity."[27] The proposals brought by the 2003 budget were passed into law on June 19, 2003,[28] and apply in respect of property acquired, as well as gifts, contributions and representations made after February 18, 2003.

As a result of this amendment, charitable donation schemes that are embodied within the definition of gifting arrangement are now "tax shelters" and therefore are required to be registered with the government and comply with all tax shelter reporting requirements, including registering and obtaining a tax shelter identification number, filing an annual information return (T5002) and tax shelter information supplementaries, T5003 (including the name, address and social insurance number of each investor, and the amount paid by each investor). Investors have to provide the tax shelter identification number to CRA before they can claim any tax credit or tax deductions.[29]

The purpose of requiring gift arrangements to be registered is to allow CRA to be able to identify and track unacceptable donation tax shelters pursuant to subsection 237.1(8). CRA has always been warning the public that the issuance of a tax shelter identification number does not indicate that CRA "guarantees an investment or authorizes any resulting tax benefits," and that CRA "only uses this identification number later to identify unacceptable tax avoidance arrangements."[30] In relation to donation tax shelters, in a fact sheet released by CRA in December 2003, CRA again reminded the public that:

> A **tax shelter number** is used for **identification purposes only**. It enables the [CRA] to identify all tax shelters and their investors but offers **no guarantee** that taxpayers will receive the proposed tax benefits. The [CRA] reviews all tax shelters to ensure that the tax benefits being claimed meet the requirements of the *Income Tax Act*. [Emphasis in original]

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[27] CRA document number 2004-0098191E5, dated February 22, 2005, is in relation to a situation where a financial institution promotes and sells flow-through shares to its customers, who may, after fully utilizing the deductions to which their shareholding entitles them, gift the shares to a registered charity. CRA was asked to provide a ruling whether such a transaction is within the definition of "gifting arrangement" because there will not be any agreement to acquire property and there is no agreement between the financial institution and the customer to donate the shares. CRA, in making reference to *Mort v. Canada*, [1993] 1 CTC 99 at 107 (TCC), citing Lord Denning in *Newton v. The Commissioners of Taxation*, [1958] 2 All E.R. 759 at 763, indicated that "the term 'arrangement' has a broad meaning and has been judicially interpreted as meaning 'something less than a binding contract or agreement, something in the nature of an understanding between two or more persons – a plan arranged between them which may not be enforceable at law."

[28] Bill-C28: *An Act to implement certain provisions of the budget tabled in Parliament on February 18, 2003*. The portion of the 2003 budget concerning donation tax shelters was briefly commented upon by Terrance S. Carter and Suzanne E. White, "Tax Shelter Donation Schemes," *Charity Law Bulletin* No. 30, December 16, 2003 (online: www.charitylaw.ca).

[29] Canada Revenue Agency, *Information Circular* IC89-4, "Tax Shelter Reporting, August 14, 1989.

[30] Canada Revenue Agency, *News Release*, "Tax Shelters," November 1997.

A similar warning is contained in CRA's latest Taxpayer Alert.[31] It has been pointed out that in spite of the repeated warnings by CRA, many people will still think that they're safe in buying these tax shelters because (1) the tax shelter has a CRA identification number, and (2) they actually receive a refund in respect of their investment in the tax shelter.[32]. The potential misunderstanding is expected to be more serious in ethnic communities in Canada where English is not their first language and where they rely entirely on the representations and advice of the promoters and advisors. It has also been suggested that CRA's warnings and recent amendments to the Act might have been used by promoters to lure taxpayers as the "last chance" to be involved in these plans before they are completely shut down.[33] Some have even suggested that this may also give incentive to promoters to sell these tax shelters to corporations.[34]

3. <u>The December 5, 2003 proposed amendments and subsequent amendments in 2004 and 2005</u>
   a) Historical overview

Prior to the 2003 federal budget, Finance proposed on December 20, 2002 to insert subsections 248(30) to (33) to the Act to "allow both an advantage to the donor and a charitable tax receipt to be issued for an 'eligible amount of a gift,' if the fair market value of the property transferred by the donor exceeds the amount of the advantage ('split-receipting')." The release of the December 2002 amendments was coupled with the release of *Income Tax Technical News No. 26* by CRA in relation to new guidelines on split-receipting.[35] These proposed changes will apply to gifts made after December 20, 2002. There was no indication that the proposed changes in December 2002 are part of an attempt to curtail donation tax shelters.[36]

On December 5, 2003, a new package of proposed amendments to the Act was released, amending the proposed changes introduced in December 2002, as well as to introduce additional changes. These additional changes include deeming the fair market value of donated property which a donor acquired through a "gifting arrangement" and in certain other situations to be the lesser of the fair market value of the donated property and the cost of acquisition of the property by the donor, and inserting a new definition for "limited-resource debt" in circumstances involving charitable donations. In the news release that accompanied the December 2003 amendments, Finance indicated that the proposed amendments were in response to concerns that

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[31] *Supra* note 1.
[32] See for example Tim Cestnick, "Donation tax schemes can come back to bite you in three years," *Globe and Mail*, December 11, 2004.
[33] DePetris, *supra* note 12 at 5B:7, and Turner, *supra* note 4, at 4.
[34] *Ibid*.
[35] Canada Revenue Agency, *Income Tax Technical News No. 26*, December 24, 2002.
[36] For an explanation of the proposed changes introduced on December 20, 2002, see Theresa L.M. Man and Terrance S. Carter, "Commentary on Draft Technical Amendments to *the Income Tax Act* Released on December 20, 2002 that Affect Charities," *Charity Law Bulletin* No. 21, April 30, 2003 (online: www.charitylaw.ca).

"various promoters are marketing charitable gifting schemes to the public in which property acquired by a taxpayer is donated to a charity at a value represented to be in excess of the taxpayer's acquisition costs" so that these "'buy-low, donate high' arrangements provide taxpayers with a tax benefit greater than their actual cost of the donated property."[37] Some of the additional changes introduced in December 2003 apply to gifts made on or after 6 p.m., Eastern Standard Time, on December 5, 2003, while other changes apply to donations made on or after February 19, 2003.[38]

Changes proposed in December 2003 were further amended and consolidated into a new set of proposed amendments released on February 27, 2004,[39] and most recently on July 18, 2005.[40]

The following is a review of the proposed amendments released in July 2005 in regard to curtailing abusive donation tax shelters. Proposed amendments released in the July 2005 amendments not relating to curtailing abusive tax shelters will not be reviewed in this paper.

In general, subsections 248(30) to (41) in relation to split-receipting, and subsection 143.2(6.1) defining limited-recourse debt in respect of gifts and political contributions are proposed to be inserted in the Act, and subsection 237.1(1) in relation to the definition of "gifting arrangement" is proposed to be amended. As a result of these proposed amendments, *Income Tax Regulations* 3501(1), (1.1), and (6) and 2000(1) and (6) are proposed to be amended to require official donation receipts to reflect the eligible amount and the amount of advantage of a gift made after December 20, 2002.

Although these proposed changes have not been enacted, the British Columbia Supreme Court in *Richert v. Stewards' Charitable Foundation*[41] upheld compliance with CRA's requirements under *Technical News* No. 26, in spite of the fact that the split-receipting rules have yet to be enacted as law. The appeal to the British Columbia Court of Appeal in January 2006

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[37] Canada, Department of Finance, *News Release*, "Government Announces Restrictions on Charitable Donation Tax Shelter Arrangements," December 5, 2003.

[38] For an explanation of the proposed changes introduced on December 6, 2003, see Theresa L.M. Man and Terrance S. Carter, "December 5, 2003 Income Tax Act Amendments Affective Charities," *Charity Law Bulletin* No. 38, February 19, 2004 (online: www.charitylaw.ca); Sandler and Edgar, *supra* note 4; and Patrick J. Boyle, "Charitable Gifts: An Update," *Report of Proceedings of Fifty-Sixth Tax Conference*, 2004 Tax Conference (Toronto: Canadian Tax Foundation, 2005), 7:1-36.

[39] See Theresa L.M. Man and Terrance S. Carter, "February 27, 2004, Revised Draft Amendments to the Income Tax Act Affecting Charities," *Charity Law Bulletin* No. 40, March 29, 2004 (online: www.charitylaw.ca); and DePetris, *supra* note 12.

[40] See Man, *Charity Law Bulletin* No. 76, *supra* note 16; and Theresa L.M. Man, "July 18, 2005 Draft Amendments to the Income Tax Act Affecting Charities: Part II – Other Changes" *Charity Law Bulletin* No. 77, September 8, 2005 (online: www.charitylaw.ca).

[41] [2005] B.C.J. No. 279.

was dismissed.[42] In this regard, CRA's *Registered Charities Newsletter* No. 17 specifically indicates that the proposed guidelines in *Income Tax Technical News* No. 26 "can be relied on now, despite the fact that the proposed legislation is not yet law."[43]

b) Eligible amount of gift

Subsection 248(31) proposes to define the "eligible amount of a gift" to be the amount by which the fair market value of the donated property exceeds the amount of the advantage in respect of the gift. In addition, pursuant to subsection 248(30), where the amount of the advantage does not exceed 80% of the fair market value of the donated property, then the existence of an advantage will not necessarily disqualify the transfer from being a gift.[44] Therefore, in order for a taxpayer involved in a donation tax shelter, it would be in his/her interest to maximize the eligible amount of the gift by maximizing the fair market value of the donated property and to minimize or eliminate any advantage received.

These subsections apply to gifts made to "qualified donees"[45] and monetary contributions made to registered political parties and candidates. Since qualified donees are organizations that can issue official donation receipts, entities other than registered charities that are qualified donees, such as registered Canadian amateur athletic associations, municipalities, prescribed universities outside Canada, etc., as well as political parties, must also be familiar with these rules and it is not open for tax shelter promoters to circumvent these rules by involving donations made to these other entities.

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[42] 2006 BCCA 9.

[43] Canada Revenue Agency, *Registered Charities Newsletter No. 17*, winter 2004.

[44] Where the transferor has received any form of consideration or benefit, it is generally *presumed* that such an intention is not present. However, the new subsection 248(30) provides the donor with an opportunity to rebut this presumption. Specifically, subsection 248(30) provides that the existence of an advantage in respect of a property transferred to a qualified donee (e.g. a registered charity) does not "in and of itself" disqualify the transfer from being a gift under two situations, namely (a) where the amount of the advantage does not exceed 80% of the fair market value of the transferred property, and (b) where the transferor establishes to the satisfaction of the Minister of National Revenue (the "Minister") that the transfer was made with the intention to make a gift. Under the latter scenario, the taxpayer would need to apply to the Minister for a determination of whether the transfer was made with the intention to make a gift.

[45] Subsection 149.1(1) of the Act provides that qualified donees are organizations that can issue official donation receipts for gifts that individuals and corporations make to them under paragraphs 110.1(1)(a) and (b) and 118.1(1). They consist of registered charities, registered Canadian amateur athletic associations, certain low-cost housing corporations for the aged, municipalities, provincial and federal governments, the United Nations and its agencies, prescribed universities outside Canada, charities outside Canada to which the federal government has made a gift in the past year, and registered national arts service organizations. In February 2004, it was proposed to amend sections 110.1 and 118.1 of the Act by including municipal or public bodies performing a function of government in Canada. This proposed amendment has been brought forth and is now included in the proposed amendments released by Finance in July 2005

c) Fair market value of donated property

One of the ways to curtail donation tax shelters is to ensure that the fair market value of the donated property is accurate. The newly proposed subsection 248(35) of the Act introduces a deeming provision that generally applies to gifts made on or after 6 p.m. (Eastern Standard Time) on December 5, 2003. Thus, the shut down of donation tax shelters operates on the basis of deeming the fair market value of the donated property to be equal to the cost of the property to the donor under certain circumstances (i.e. the "Deeming Provision").

Specifically, the opening wording of subsection 248(35) provides that the fair market value of the donated property, for purposes of determining the eligible amount of the gift, is *deemed* to be the lesser of (1) the "fair market value of the property otherwise determined" and (2) the cost (or the adjusted cost base in the case of capital property) of the property to the donor immediately before the gift is made. This Deeming Provision applies if (a) the donated property was acquired by the donor as part of a gifting arrangement,[46] or (b) the donated property was acquired under two other situations,[47] namely, (i) if the property was acquired by the donor less than 3 years before making the gift,[48] and (ii) if the donor acquired the property less than 10 years before making the gift and it is "reasonable to conclude" that, at the time when the donor acquired the property, "one of the main reasons" for the acquisition of the property was to make a gift to a qualified donee.[49]

The Deeming Provision does not apply to donation of inventory, real property or an immovable[50] situated in Canada, certified cultural property, publicly traded shares or ecological gifts.[51] It also does not apply to circumstances involving a shareholder transferring property to a controlled corporation in exchange for shares issued by the corporation, and then donating the shares to a charity, or having the corporation donate the shares to a charity. Furthermore, if subsections 85(1) or 85(2) of the Act applied to the transfer of such an exempt property to the corporation, the Deeming Provision also would not apply if it were then donated by the corporation.[52] Furthermore, the three-year and the ten-year hold periods set out in paragraph 248(35)(b) do not apply where the gift is made as a consequence of the death of the donor.[53]

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[46] Paragraph 248(35)(a).
[47] Paragraph 248(35)(b).
[48] Paragraph 248(35)(b)(i).
[49] Paragraph 248(35)(b)(i).
[50] The reference to "immovable" is introduced by the July 2005 amendments.
[51] Paragraphs 248(37)(a), (b), (c) and (d).
[52] Paragraphs 248(37)(e) and (f), which were introduced by the July 2005 amendments.
[53] See the opening wording of paragraph 248(35)(b). See also subsection 248(10) of the Act for the meaning of "series of transactions."

The application of the Deeming Provision to all property acquired by the donor from a gifting arrangement pursuant to paragraph 248(35)(a) would have been sufficient in shutting down all donation tax shelters. Presumably, once the fair market value of the donated property is deemed to be the same as the cost paid by the taxpayer, the ability of the taxpayer to claim a donation tax credit in excess of his/her economic outlay would be eliminated.

However, Finance went even further by expanding the Deeming Provision to situations whether the donated property is not acquired through gifting arrangements by proposing the three-year and ten-year hold periods in paragraph 248(35)(b) and the "look-back" rules under subsection 248(36). It is not clear why Finance went the extra step in proposing the application of the Deeming Provision to the three-year and the ten-year hold periods. It has been suggested that perhaps Finance was being cautious in order to catch all potentially objectionable schemes that, for some reason, does not fall squarely within the definition of a gifting arrangement as defined in the Act. An example would be to shut down "home-made" type of donation schemes that do not involve any representations or statements made in connection with the arrangement that is required in order to qualify as a gifting arrangement.[54]

Therefore, under scenario (1), if a donor acquired a property and donated the property within 3 years from the date of acquisition, then the fair market value of the property would be deemed to be the donor's cost (or adjusted cost base in the case of capital property) regardless of whether the donor had the intention to make a gift when the property was acquired. Under scenario (2), if the donor acquired the property within 10 years[55] prior to making the gift, as long as it is *reasonable* to conclude that *one of the main reasons*[56] why the donor acquired the property was to make a gift, then the Deeming Provision would apply. The burden is on the donor to prove that he or she did not have such an intention. Although it would appear that the purpose of subparagraph 248(35)(b)(ii) (i.e. scenario (2)) is intended to apply where the acquisition of the property by the donor was outside of 3 years but within 10 years, this has not been made clear in the proposed wording of the legislation.

Furthermore, the July 2005 amendments also introduced a new subsection 248(36) to "look back" to situations where a donated property was previously acquired by a person or a partnership dealing at non-arm's length with the donor within the respective 3-year or 10-year

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[54] Sandler and Edgar, *supra* note 4 , at 2211.

[55] The 10 year holding period is introduced by the July 2005 Amendment. In the February 2004 amendments, subparagraph 248(35)(b)(ii) applies to the entire life time of the donor.

[56] The February 2004 amendments provided that the donor "expected to make a gift of the property" at the time when the property was acquired by the donor. However, the July 2005 amendments now provides that it is not necessary that the *only* reason for the donor to acquire the property was to make a gift (as previously required by the February 2004 amendments), but simply that *one of the main reasons* that the donor acquired the property was to make a gift. This has lowered the threshold required under subparagraph 248(35)(b)(ii) considerably.

period in relation to gifts made on or after July 18, 2005. In those situations, the cost (or adjusted cost base in the case of capital property) of the property[57] to the donor immediately before the gift is made would be deemed to be the lower of the donor's cost and the lowest cost to any such non-arm's length person or partnership. The intention of subsection 248(36) is to prevent a donor from artificially increasing his or her cost by acquiring it from a non-arm's length person at an inflated amount. This provision is also intended to include situations where a person not at arm's length has acquired the property within the relevant period, notwithstanding that another person at arm's length has also acquired the property in a chain of transactions within that period.[58] However, it is not clear when the non-arm's length test would apply, e.g. at the time when the donation was made, at the time when the donor acquired the property, or at the time when another non-arm's length person acquired the property within the respective hold periods.

d) Broad definition of advantage

As explained above, in order for a taxpayer involved in a donation tax shelter, it would be in his/her interest to minimize or eliminate the amount of any advantage received. This portion of the paper reviews the attempts of Finance to increase the amount of advantage in the equation in order to reduce the eligible amount on the charitable receipt issued to the taxpayer.

A broad definition of "amount of the advantage" in respect of a gift or monetary contribution by a taxpayer is proposed in subsection 248(32) of the Act. It was first introduced by the December 2002 amendments and was substantially amended by both the December 2003 and February 2004 amendments. This definition was again revised in the July 2005 amendments.[59] However, the Act does not contain a definition of the term "advantage," which carries an extremely broad meaning at common law.[60] The proposed definition of the amount of the advantage includes two parts:

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[57] For purposes of determining the deemed fair market value under subsection 248(35).

[58] Consider the example where A acquires a property from a person at arm's length, then sells the property to B who sells the property to C, and C donates the property to a charity, all within a 3-year period. Assuming A and C are in a non arm's length relationship, while B is arm's length with A and C, then the cost to C would be deemed to be the lower of A's cost and C's cost. If this chain of transactions occurred within a 10 year period, the same result would be reached provided that one of the main reasons for C (rather than A) acquiring the property was to make a gift. However, if the property was *acquired* by A outside of the 10-year period, then subsection 248(36) would not apply.

[59] For a detailed review of the meaning of "advantage," see Hoffstein, Man and West, *supra* note 16.

[60] Firstly, it can be seen that courts have appreciated the vast general scope of the term, with one judge holding that "the words 'gain advantage' could scarcely be more general in their scope." Secondly, no doubt due to this fact, courts have interpreted the term broadly in diverse legal contexts. See for example, *R. v. Marsh* (1975), 31 C.R.N.S. 232 at 237 (Ont. Co. Ct.), a criminal matter, where the court stated that "'[a]dvantage' is not confined to an economic, proprietary, or monetary advantage but the word must be interpreted in a much broader dictionary sense. 'Advantage' is defined in the Concise Oxford Dictionary as meaning, amongst other things, 'better position, precedence, superiority or favourable circumstance.'"

- Paragraph 248(32)(a) of the Act provides that the amount of the advantage in respect of a gift includes the value, at the time when the gift is made, of "any property, service, compensation, use or other benefit"[61] that the donor, or a person or partnership who does not deal at arm's length with the donor[62] has "received, obtained or enjoyed, or is entitled, either immediately or in the future and either absolutely or contingently, to receive, obtain or enjoy" that is (i) in consideration of, (ii) in gratitude of, or (iii) in "any other way related to" the gift.[63] Paragraph 248(32)(a) applies to gifts made after December 20, 2002, save and except that the provision concerning the phrase "in any other way related to" the gift applies to gifts made on or after 6 p.m. (Eastern Standard Time) on December 5, 2003.
- Paragraph 248(32)(b) of the Act provides that an advantage would also include the amount of limited-recourse debt (as determined pursuant to the newly proposed subsection 143.2(6.1)) in respect of a gift or monetary contribution at the time when the gift or monetary contribution is made. The purpose of this proposed amendment is to curtail abusive tax shelter schemes involving limited-recourse debts. This paragraph applies to gifts made on or after February 19, 2003.

Although this presents a fairly comprehensive formula for determining the proper amount of an advantage, it is also, like many other such formulae in the Act, complex and difficult to determine in practice, partly due to the sheer breadth of the definition of what constitutes an advantage for the purposes of the Act and partly due to the fact that, as the CRA has stated, "whether or not there is an advantage in respect to a donation is a matter of fact."[64] The explanatory notes to the proposed amendments indicate that subsection 248(32) is intended "to apply in respect of any transaction or series of transactions having either the purpose or the effect of reducing the economic impact to a donor of a gift or contribution."

e) Limited-recourse debts as advantage and payment of limited-recourse debts

As indicated above, in addition to the donation of property to charities under the gifting arrangements, another type of gifting arrangement which Finance felt the need to restrict involves limited-recourse debts incurred by donors (also known as "leveraged loans" or

[61] The reference to "use" is introduced by the July 2005 amendments.
[62] The reference to "another person or partnership who does not deal at arm's length with and holds, directly or indirectly, an interest in the taxpayer" that was introduced by the February 2004 amendments has not been included in the July 2005 amendments.
[63] The reference to "in any other way related to" the gift in subparagraph 248(32)(a)(iii) was introduced by the December 2003 amendments.
[64] Canada Revenue Agency, document number 2004-0101311E5, November 29, 2004.

"leveraged donation shelters"). It has been explained how a typical leveraged donation shelters operates earlier in this paper.[65]

In addition to the amendment of the Act brought by the 2003 budget, referred to above, by expanding the definition of "tax shelter" to include "gifting arrangements" involving limited-recourse debts, the December 2003 amendments also proposed to curtail the use of arrangements involving limited-recourse debts by introducing a series of other amendments to the Act. These amendments include inserting subsection 143.2(6.1), subsection 248(34), and 248(32)(b), as well as amending the wording of subsection 143.2(13) before paragraph (a). These amendments only apply to donations made after February 18, 2003.

The proposed paragraph 248(32)(b) of the Act provides that an advantage includes a "limited-recourse debt" in respect of a gift or monetary contribution at the time when the gift or monetary contribution is made. Therefore, the eligible amount to be reflected in a donation receipt for a gift involving a limited recourse debt would be reduced by the amount of the said debt.

"Limited-recourse debt" is defined in the newly proposed subsection 143.2(6.1) of the Act. The definition contains two aspects. First, pursuant to paragraphs 143.2(6.1)(a) and (b), a "limited-recourse debt" is a "limited-recourse amount" that can reasonably be considered to relate to the gift or monetary contribution. "Limited-recourse amount" is defined in subsection 143.2(1) to mean the unpaid principal amount of any indebtedness for which recourse is limited. The limitation is not restricted to situations where it is immediate or absolute, but it also includes a limitation that applies in the future or contingently. Furthermore, such an indebtedness is also a limited-recourse debt if it is owed by a person dealing non-arm's length with the taxpayer or by a person who holds an interest in the taxpayer. In situations where recourse is not limited, the unpaid principal of any debt may also be "deemed" to be a limited-recourse debt under subsection 143.2(7) of the Act, unless (1) there are *bona fide* arrangements in writing at the time when the debt arose to repay the debt and all interest within a reasonable period not exceeding 10 years, and (2) interest is paid at least annually, within 60 days after the debtor's taxation year, at not less than CRA's prescribed interest rate. In addition, pursuant to subsection 143.2(8), where the debtor is a partnership, if the recourse against any member of the partnership is limited either immediately or in the future and either absolutely or contingently, the unpaid principal of the debt would also be deemed to be a limited recourse amount. Second, pursuant to paragraph 143.2(6.1)(c), a "limited-recourse debt" also includes *any* indebtedness related to a gift or political contribution, whether or not recourse is limited, that can "reasonably be considered to

[65] See page 3 above.

relate to the gift or monetary contribution," for which there is a "guarantee, security or similar indemnity or covenant" in respect to that debt or "any other indebtedness."

The cumulative effect of the paragraph 248(32)(b) and subsection 143.2(6.1) is to reduce the amount of the gift by the amount of the loan borrowed by the donor if the indebtedness is of limited recourse to the lender or if there is a "guarantee, security or similar indemnity or covenant" in respect to that debt or any other debts. The explanatory notes to the July 2005 amendments explain that such a broad definition of "limited-recourse debt would include a situation whether a donor (or any person dealing non-arm's length with the donor or a person who holds an interest in the donor) enters into a contract of insurance whereby all or part of a debt will be paid upon the occurrence of either a certain or contingent event, the debt is a limited-recourse debt in respect of a gift if it is in any way related to the gift."

The newly proposed subsection 248(34) would deem repayments of the limited-recourse debt as gifts in the year it is repaid. This subsection applies to gifts made on or after February 19, 2003. Subsection 248(34) provides that a repayment of the principal amount of a limited-recourse debt in respect of a gift or monetary contribution is deemed to be a gift in the year it is paid. However, where the total amount of limited-recourse debt and other advantages to the donor exceed the fair market value of the property transferred to the charity, it would result in no eligible amount available to the donor. In such cases, the donor would need to pay off the excess amount before any amount will be allowed as a gift. The explanatory notes to the proposed amendment also explain that a payment financed by other limited-recourse debt or made by way of assignment or transfer of a guarantee, security or similar indemnity or covenant is not recognized for these purposes. An example would include the assumption of a taxpayer's limited-recourse debt by another person, in exchange for an insurance policy in favour of the taxpayer that guarantees a particular rate of return on an investment held by any person, would not qualify as a deemed gift under subsection 248(34). It is not clear how this provision would apply in practice, e.g. would a donation receipt need to be issued in respect of the repayment of such a debt, and if so, how would it impact the charity's disbursement quota?

Subsection 143.2(13) of the Act currently deems an indebtedness to be a limited-recourse debt where information related to an indebtedness in respect of an "expenditure" is located outside of Canada and the Minister of National Revenue is not satisfied that the indebtedness is not a limited-recourse amount, unless the taxpayer provides the information to the Minster or the information is located in a country with which Canada has a tax convention or treaty that gives the Minister the power to obtain the information. This provision is proposed to be expanded to apply to gifts or monetary contributions made after February 18, 2003 in respect of an indebtedness, in addition to the taxpayer's expenditure.

f) Other advantages

This broad definition of “the amount of the advantage” in subsection 248(32)(a) has very serious implications. It is conceivable that the broad definition of the “amount of the advantage” is intended to include other types of benefits related to gifts made through gifting arrangements as “advantage,” thereby reducing the eligible amount of donation receipts. The broadness of the “the amount of the advantage” could be seen as follows:

- The value of the amount of an advantage is the total value of any “property, service, compensation, use or other benefit” in question;
- The valuation of an advantage is based on the time when the gift is made;
- An advantage includes something that (1) is received, obtained, or enjoyed by someone or (2) someone is “entitled, either immediately or in the future and either absolutely or contingently” to receive, obtain or enjoy. The advantage could be (i) in consideration of, (ii) in gratitude of, or (iii) in any other way related to the gift. The explanatory notes to the proposed amendments indicate that an advantage may have been received “prior to the time of the gift or may be contingent or receivable in the future.” Furthermore, it does not appear necessary for a causal relationship to exist between the making of the gift and the receiving of the advantage if they are “in any other way” related to each other;
- The explanatory notes indicate that an advantage may accrue either to the donor or to a person or partnership not dealing at arm’s length with the donor; and
- The definition of advantage is silent regarding by whom the advantage may be provided. The explanatory notes provide that “it is not necessary that the advantage be received from the charity that received the gift.” Presumably, it could include an advantage provided by a third party, even unbeknownst to the charity issuing the charitable donation receipt.

When calculating the amount of the advantage, subsection 248(33) of the Act provides that the cost of property acquired by the donor in the course of making a gift is the fair market value of the property at the time when the gift is made. This subsection applies to gifts made after December 20, 2002.

The explanatory notes to the proposed amendments indicate that the following are examples of an advantage:

> This includes, for instance, situations where a charity invests funds or acquires property in a manner that benefits the donor. … An example would include the option of a donor to satisfy or pay a loan by assigning or transferring to another person a property (including the

> rights under an insurance policy) that has less economic value than the amount of loan outstanding. Another example would include an assumption of a donor's risk by a charity, where the acquisition, directly or indirectly, of an interest in a property of the donor by the charity may have the effect of reducing the potential loss of the donor from that investment.

In CRA's 2004 fact sheet,[66] CRA also indicated that the receipt of property by the taxpayer from a trust in a trust gifting arrangement is an advantage and the donation amount will be reduced accordingly.

g) Anti-avoidance rule

Subsection 248(38) was first introduced by the December 2003 amendments in order to prevent a donor from avoiding the application of the Deeming Provision set out in subsection 248(35) by disposing of and reacquiring a property before donating it to a qualified donee. This subsection was included, unchanged, in the February 2004 amendments, but was amended in the July 2005 amendments.

Pursuant to this subsection, for gifts made on or after July 18, 2005, the eligible amount of a gift is deemed to be nil if a transaction or a series of transactions either (i) has, as one of its purposes, the avoidance from the application of subsection 248(35), or (ii) would otherwise result in a tax benefit to which the general anti-avoidance rule in subsection 245(2) would otherwise apply.[67] However, for gifts made on or after 6 p.m. (Eastern Standard Time) on December 5, 2003, but before July 18, 2005, the original wording introduced by the December 2003 amendments would apply, i.e. if "it can reasonably be concluded that one of the reasons for a series of transactions" that includes a disposition or acquisition of property of a donor is to increase the amount that would be deemed to be the fair market value of the gift under subsection 248(35), then the cost of the property shall be deemed to be the lowest cost to the donor to acquire the property in question or "an identical property at any time."

h) Substantive gifts

The February 2004 amendments introduced a new subsection 248(38) that applies to gifts of capital property and eligible capital property made on or after February 27, 2004. Subsection 248(39) is included in the July 2005 amendments with minor changes.

Subsection 248(39) is intended to prevent a donor from avoiding the application of the Deeming Provision set out in subsection 248(35) by disposing of property to a qualified donee

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[66] Canada Revenue Agency, *Fact Sheet*, "*Tax Shelter Donation Arrangements,* " November 25, 2004.
[67] The reference in paragraph 248(38)(b) to the general anti-avoidance rule in subsection 245(2) is introduced by the July 2005 amendments.

and then donating the proceeds of disposition (rather than donating the property itself) to either that qualified donee or to another qualified donee that does not deal at arm's length with the qualified donee that purchased the property from the donor. The property disposed of by the donor is referred to as a "substantive gift" in this subsection. Under these situations, the Deeming Provision would apply and the fair market value of the substantive gift (i.e. the proceeds of sale) would be "deemed" to be the lesser of the fair market value of the substantive gift and the cost (or the adjusted cost base in the case of capital property) of the substantive gift to the taxpayer immediately before its disposition to the qualified donee. This subsection does not apply if subsection 248(35) would not have applied to a gift by the taxpayer of that property.

E. Other Steps to Shut Down Donation Tax Shelters

Other than introducing legislative amendments to the Act to reduce the eligible amount on donation receipts issued to individuals involved with donation tax shelters, CRA has been taking other active steps to shut down abusive donation tax shelters schemes. This section of the paper provides an overview of these steps.

1. Education of the public and registered charities
   a) CRA fact sheets and warnings to the public

One of the ways to shut down unacceptable donation tax shelters is to warn the public and registered charities of the risks associated with involvement in such schemes. Over the years, CRA has issued various fact sheets, news releases and "taxpayer alerts" in this regard.

As early as 1997, CRA had been warning investors of the "potential risks and problems" associated with tax shelters.[68] Similar warnings were contained in fact sheets issued between 1998 and 2001.[69] These fact sheets explained what unacceptable tax shelters were, the consequences of being involved with these tax shelters, how investments may "avoid trouble," the fact that tax shelter identification numbers do not legitimize investments, and that advance income tax rulings do not guarantee deductions.

[68] Canada Revenue Agency, News Release, supra note 30.

[69] Canada Revenue Agency, *Fact Sheet*, "What is a tax shelter?" January 1998, *Fact Sheet*, "Canada Customs and Revenue Agency Reminds Investors of Risks Associated with Tax Shelters," November 2000; *Tax Tips*, "Tax shelters: Advance income tax rulings do not guarantee deductions," August 14, 2001; and *Fact Sheet*, "What is a Tax Shelter?" January 2002. At that time, the main concern of CRA was in relation to tax shelters involving business losses that were claimed by investors. For example, tax promoters invited investors to purchase in a "partnership" and allowed the investors to claim losses incurred by the partnership in the investor's personal income tax returns. In those situations, CRA's concerns included a lack of business activity or an activity with no reasonable expectation of profit, expenses that are unreasonable of inflated, assets of the business are overhauled, the expense are unreasonably high, losses for tax purposes exceeds the amount of the investment actually "at risk," etc. For example, see *Peter Brown v. The Queen*, 2003 DTC 5298 (C.A.), involving software tax shelters.

As tax shelters involving donation of artwork were introduced, CRA began warning the public in 1999 to be wary of them.[70] CRA explained its concerns regarding art-donation schemes or "art-flips" in more detail in its Fact Sheet in 2002.[71] Although the fact sheet deals mainly with the donation of works of art, the donation of "another item of speculative value" is also referred to in the fact sheet. It also warns the public that the donation claimed will be disallowed or adjusted if it is determined that the "donation is not a true gift or that the work of art's appraised value is inflated" and that penalties may also apply. In addition, promoters, appraisers, and advisors may be subject to third-party penalties for making false statements or omissions. Charities may also be subject to third-party penalties "if it knew – or it can reasonably be expected to have known – that the appraised values were incorrect" or have their charitable status revoked.

The growing number of donation tax shelters was a serious concern to CRA. On November 25, 2003, CRA released another fact sheet, which again provided warnings and guidelines with respect to tax shelter donation schemes involving the donation of "various items … such as art, computers, and prescription drugs."[72] Warnings were extended to donations made to registered Canadian amateur athletic associations.

Similar warnings are also contained in CRA's fact sheet issued in November 2004.[73] It indicated that CRA is "aware that some donation arrangements continue to be promoted," namely gifting trust arrangements and leveraged cash donations. It indicated that it is "CRA's position that the December 5, 2003 amendments apply to these arrangements and will reduce their associated tax." Most recently, similar warnings were set out in CRA's "taxpayer alert" issued in November 2005.[74]

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[70] Canada Revenue Agency, Fact Sheet, "Canada Customs and Revenue Agency Issues Warning on Art Donation Scheme," December 1999.

[71] Canada Revenue Agency, *Fact Sheet*, "Art-donation Schemes or 'Art-Flipping,'" November 2002. CRA explains what an "art-donation or 'art-flipping' scheme" is as follows:

> Step 1: A promoter gives a person the opportunity to purchase one or more works of art or another item of speculative value at a relatively low price. The proposal is that the promoter will work with the person to make arrangements for donating the works of art or other items to a Canadian registered charity or other specified institution. Step 2: The person donates the art or other item and receives a tax receipt from the charity or other specified institution that is based on an appraisal arranged by the promoter. The appraised value of the art is substantially higher than the cost paid by the person. Step 3: When the person claims the receipt on his or her next tax return, it generates a tax saving that is higher than the amount paid for the art in the first place.

[72] Canada Revenue Agency, *Fact Sheet*, "*Tax Shelter Donation Arrangements,* " November 25, 2003.

[73] *Supra* note 66.

[74] *Supra* note 1.

b) CRA's publications for registered charities

It is also important for CRA to ensure that the charitable sector is aware of CRA's concerns regarding donation tax shelters. In addition to the above-mentioned various fact sheets, news releases and "taxpayer alerts," CRA also warns and educates the charitable sector of the risks involved with these donation schemes and the need to be wary when involved in these schemes through a series of other publications, including the following:

- *Registered Charities Newsletter No. 8*[75] — CRA warned that charities that "knowingly" received "gifts of art and issuing receipts to the donor for an amount well above the fair market value for the art" are at risk of losing their charitable status on the grounds that they have issued receipts "that contain false information." Other charities that are "misled by appraisals in the possession of the donor which have led them to issue a tax receipt for a amount far greater than the amount they can obtain by selling the art work" and therefore issuing receipts "for an inflated amount" will have problems meeting their disbursement quota the following year." As a result, CRA advised charities to "rely on common sense and to make sure they get an independent appraisal of the artwork by a competent professional" who is "a person who is not financially connected to the donor, the charity the art dealer, or the artist."
- *Registered Charities Newsletter* No. 14[76] — CRA indicated that "a series of test cases confirmed CRA's ability to disallow the inflated claims on donation receipts, and charities involved in these activities have been deregistered." CRA indicated that the cases of 5 taxpayers were selected to go before the Tax Court of Canada as a test. At issue in these cases was "whether these individuals had made true donations, whether the value attributed to the works for donation purposes was their fair market value, and whether a penalty for gross negligence was appropriate." In addition to finding that these individuals were only entitled to claim tax credits for the fair market value of the art works donated at 25% of the value claimed, the registered charities involved in those cases were deregistered. The art dealer involved also received a jail sentence when his case was brought before the Superior Court of Quebec.
- *Registered Charities Newsletter* No. 16[77] — Charities were reminded that the donation of items of "speculative value" could involve "trading cards, comic books, and used cars, where a promoter facilitates the donations to the charity."

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[75] Canada Revenue Agency, *Registered Charities Newsletter No. 4,* Spring 1999.
[76] Canada Revenue Agency, *Registered Charities Newsletter* No. 14, Winter 2003.
[77] Canada Revenue Agency, *Registered Charities Newsletter* No. 16, October 9, 2003.

- Summary Policy on "Tax Shelters"[78] — CRA issued a summary policy which states that "[u]nder the *Income Tax Act*, a tax shelter includes any property or gifting arrangement for which a promoter represents that an investor can claim deductions or credits which equal or exceed the cost of the property less certain benefits within a four year period."
- *Registered Charities Newsletter No. 18*[79] — CRA again reminded charities of the consequences of participation in abusive tax shelter donation arrangements.
- *Registered Charities Newsletter No. 21*[80] — CRA reminded charities of the issuance of the Fact Sheet in November 2004. It indicates that CRA "wants to make sure potential donors know about the risks associated with participating in certain tax shelter donation arrangements, including gifting trust arrangements, leveraged cash donations, and buy-low, donate-high arrangements."

2. <u>Reassessments of taxpayers/donors and court challenges</u>

CRA's fact sheet released in November 2004,[81] indicates that "potential investors should be aware of the risks associated with participating in certain tax shelter donation arrangements, including gifting trust arrangements, leveraged cash donations, and buy-low sell-high arrangements," and that "CRA will challenge any arrangement that does not comply with the [Act] and will audit the tax returns of investors with respect to their participation in such an arrangement." CRA recommends that "anyone considering participating in tax shelter donation arrangements obtain independent legal and tax advice." CRA's recent taxpayer alert in 2005,[82] warns that "the fact that investors in some of these tax shelter donation arrangements have not been reassessed should not be interpreted as the CRA's acceptance of the arrangement" and that "such audits may take more than one year to complete."

In its 2003 fact sheet, CRA indicated that it has reassessed approximately 5,000 individuals involved in donation arrangements, with some of them having filed notices of objection and appeals to the tax court. It also indicates that CRA was at that time auditing another 5,000 individuals involving various donation arrangements.

CRA's aggressive reassessments on taxpayers involved donation tax shelters and art-flips have led to a number of cases in the tax court. In general, the challenges by CRA have been on different fronts, including the issue of whether there is a gift, whether the receipts reflect the fair

[78] Canada Revenue Agency, *Summary Policy* CSP-T08, "Tax Shelter," November 26, 2003.
[79] Canada Revenue Agency, *Registered Charities Newsletter No. 18,* April 2004.
[80] Canada Revenue Agency, *Registered Charities Newsletter No. 21,* January 2005.
[81] Canada Revenue Agency, *Fact Sheet*, "Tax Shelter Donation Arrangements," November 2004.
[82] *Supra* note 1

market value of the property,[83] whether there is any donative intent (in some situations, the donor never had possession of the property before they were donated to charities), whether the property was personal-use property, and whether the appraisals obtained by tax shelter promoters could be relied upon when issuing the donation receipt. CRA's 2003 fact sheet[84] indicates that the transactions described below may be challenged by CRA:

- the advertised arrangements promise to sell items (such as art, software, or pharmaceuticals) to taxpayers to be donated immediately to selected charities for tax receipts that are much higher than what the person paid;
- the appraiser is not acting independently of the promoters or sellers of the arrangement or the charities involved;
- the fair market value seems too high;
- where the arrangement involves a loan where it's unlikely the person has to repay the loan because the lender's recourse to collect is limited, or the provision to settle the loan is by way of something other than cash payment from the taxpayer.

A detailed review of these cases is outside the scope of this paper.[85] However, worth mentioning is the most recent decision by the Federal Court of Appeal in *Nash v. Canada* ("*Nash*"),[86] overturning the decision by the Tax Court of Canada. *Nash* is a consolidation of actions brought by three taxpayers[87] on behalf of 1,850 taxpayers who purchased groups of limited edition prints from a promoter, CVI Art Management. The prints were then donated within a few months to charities, which issued donation receipts for amounts approximately three times higher than the price paid by the taxpayers. The Federal Court held that the correct value of the donated artwork was the actual purchase price paid by the taxpayers, rather than the aggregate of the price that the individual pieces of artwork could be sold for. The outcome of *Nash* is similar to the Federal Court of Appeal's decision in *Klotz v. Canada* ("*Klotz*").[88] Both *Nash* and *Klotz* are under appeal to the Supreme Court of Canada.

Many of the tax shelters promoters indicate that a sum of money is set aside as a legal defence fund in the event of a reassessment by CRA, whereby a test case might be chosen and

[83] In CRA document number 2003-0023835, November 21, 2003, CRA as asked comment on a hypothetical scenario involving the purchase of software at a discount from its fair market value and subsequent donation to a registered charity or a charitable organization outside of Canada. On the issuance of a receipt by the charity that received the property, CRA indicated that "the issuance of a receipt is not, in and of itself, determinative of whether a particular transaction was a gift or of the fair market value of the property at the time that it was transferred."

[84] *Supra* note 72.

[85] For a summary review of recent cases, see Karen Cooper, "Beware of Donation Tax Shelter Valuations," *Charity Law Bulletin* No. 87, February 8, 2006.

[86] [2005] F.C.J. 1921 (C.A.); rev'g 2004 DTC 3391 (T.C.C.). The TCC *Nash* case was held together with *Quinn v. The Queen*, 2004 DTC 3328 (TCC) and *Tolley v. The Queen*, 2004 DTC 3360 (TCC).

[87] Caedmon Nash, Barbara Quinn and Susan Tolley.

[88] [2005] F.C.J. No. 754 (C.A.); aff'g [2004] T.C.J. No. 52 (T.C.C.).

the entire program would be tested based on that one case. However, it is possible that such a defence fund might not be sufficient to respond to CRA's reassessments, including all subsequent appeals through the court system. In addition, in the event that a charity be named in such proceedings, or a charity be audited by CRA as a result of its involvement with an unacceptable tax shelter, it is not clear whether such fund would be available for the charity's defence.

3. Audits on registered charities and to obtain donor information

In addition to reassessing taxpayers involved in unacceptable donation tax shelters, CRA has also been very active in conducting audits of charities. CRA completed 369 audits of registered charities in 2004[89] and 356 audits in 2003. CRA indicated that it is introducing "an enhanced compliance regime," including having "expanded [its] audit capacity and completed the training of new field auditors, and put into place monitoring and quality control procedures."[90]

As part of the audit process, CRA is also obtaining donor information from the charities being audited in order to assist CRA's tax avoidance investigation or to reassess the donors. See for example the recent case of *All Saints Greek Orthodox Church v. M.N.R.*,[91] CRA applied to the court for an order authorizing it to require the Church furnish a list of all persons who made donations to it of comic books and trading cards. CRA had already obtained the information from the Church in the course of the audit, but it was not able to use the information to assist its tax avoidance investigation involving the donors unless an order was granted under section 231.2. Although the court granted the order sought by CRA, since CRA has already used the information to reassess the donors, CRA was ordered to pay costs on a solicitor and client basis.

4. Audits on tax shelter promoters

In CRA's various fact sheets and news releases, CRA has repeatedly indicated that the tax shelter identification number allows CRA to identify all tax shelters and their investors. This also allows CRA to review and audit these shelters to ensure that they comply with the requirements of the Act.

5. Establish centres to fight aggressive international tax planning

The issue of shutting down abusive tax shelters is a high priority with the federal government. On April 23, 2004, the governments of Canada, Australia, United Kingdom and the United States agreed to establish a Joint International Tax Shelter Information Centre, which will

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[89] Canada Revenue Agency, *Registered Charities Newsletter* No. 23, June 2005, based on CRA's fiscal year from April 2004 to March 2005.

[90] Canada Revenue Agency, *Registered Charities Newsletter* No. 24, Summer 2005.

[91] 2006 DTC 6264 (F.C.). In *Redeemer Foundation v. Canada* 2005 DTC 5617 (F.C.), after having audited a charity that operates a "forgivable loan program," CRA obtained from the charity, upon a verbal request, donor information with which CRA contacted the donors that they would be reassessed to disallow the donation tax credits claimed for their donations to the charity.

assist the respective tax administrations in addressing challenges arising from abusive tax transactions. In a news release by the federal government on May 3, 2004, it indicates that an initial focus of the work will include the ways in which financial products are used in abusive tax schemes by corporations and individuals to reduce their tax liabilities and the identification of promoters developing and marketing those products.[92] In a fact sheet issued in August 2005, CRA indicates that it is establishing 11 Centres of Expertise across Canada "to strengthen and enhance its audit and collection programs to counter international tax avoidance and evasion and aggressive international tax planning" and to "develop new ways to track and combat aggressive tax planning and the use of international tax shelters."[93]

F. Consequences of Non-Compliance

1. Reassessment of taxpayers and penalties

As indicated above, taxpayers involved in unacceptable donation tax shelters will be reassessed by CRA to reduce or disallow tax credits or deductions claimed. In addition, in some circumstances, penalties may also be imposed on taxpayers. In this regard, CRA warned in its fact sheet issued in 2003 as follows:[94]

> Whether penalties will be applied in a particular situation depends on the facts and circumstances of the taxpayer's case. They may be applied in those situations where donors knowingly accepted and did not question appraised values far in excess of the cost of the property. The [CRA] weighs such things as the amount and nature of the understated income, the individual's knowledge of tax matters, and the degree to which the individual participated in preparing his or her return.

Subsection 163(2) imposes an administrative "gross negligence" penalty on a taxpayer who "knowingly, or under circumstances amounting to gross negligence, has made or has participated in, assented to or acquiesced in the making of, a false statement or omission" for purposes of the Act. In this regard, the court in *Lucien Venne v. Her Majesty the Queen*,[95] held as follows when deciding whether to impose a penalty under subsection 163(2) of the Act:[96]

> "Gross negligence" must be taken to involve greater neglect than simply a failure to use reasonable care. It must involve a high degree of negligence tantamount to intentional acting, an indifference as to whether the law is complied with or not.

Furthermore, in 2000, the court in *897366 Ontario Ltd. v. Canada*[97] held that the

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[92] Canada Revenue Agency, *News Release*, "Canada, Australia, United Kingdom and the United States agree to establish a Joint International Tax Shelter Information Centre," May 3, 2004.
[93] Canada Revenue Agency, *Fact Sheet*, "Aggressive International Tax Planning Centre of Expertise," August 2005.
[94] *Supra* note 72.
[95] 1984 CarswellNat 210, [1984] C.T.C. 223, 84 D.T.C. 6247 (F.C.T.D.)
[96] *Ibid* at para. 37.
[97] [2000] T.C.J. No. 117, [2000] G.S.T.C. 13 (T.C.C.).

imposition of a penalty under section 285 of the *Excise Tax Act*, which contains substantially similar wording to subsection 163(2), "requires a serious and deliberate consideration by the taxing authority on the taxpayer's conduct to determine whether it demonstrates a degree of wilfulness or gross negligence justifying the penalty … the penalties may only be imposed under section 285 in the clearest of cases, and after an assiduous scrutiny of the evidence."[98]

2. Third-parties penalties

Third-party penalties were introduced in 2000. The objective of the third-party civil penalties is "to deter third parties from making false statements or omissions in relation to income tax or goods and services tax/harmonized sales tax (GST/HST) matters" and that "[t]hese penalties are directed at ensuring tax compliance by deterring behaviour that results in non-compliance."[99] Subsection 163.2 of the Act provides for two penalties, one directed primarily at those who prepare (or participate in), sell or promote a tax shelter or tax shelter-like arrangements, and the other directed at those who provide tax-related services to a taxpayer.[100] The first of these two penalties is the "planner penalty" and the latter is the "preparer penalty." CRA summaries these penalties as follows:[101]

> "Planner Penalty"
> 7. Subsection (2), the "planner penalty," provides for a penalty on a person who makes, furnishes, participates in the making of, or causes another person to make or furnish a statement that the person knows, or would reasonably be expected to know but for circumstances amounting to culpable conduct, is a false statement that could be used by another person for a purpose of the ITA or for a purpose of the ETA. Unlike the preparer penalty (defined in paragraph 9), the person who could use the false statement does not need to be identified in order to apply this penalty. Examples of when this subsection could be applicable are:
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> - tax shelter promoters holding seminars or presentations to provide information in respect of a specific tax shelter; and

[98] *Ibid*. at para. 19 See also *Drozdzik v. Canada*, [2003] 2 C.T.C. 2183 (T.C.C.), where the court made the following comment at para. 290 about imposing a penalty under subsection 163(2) of the Act:

> This is a penal section. It has extreme consequences for the taxpayer and should only be resorted to on evidence which makes it clear that the taxpayer has knowingly, or under circumstances amounting to gross negligence, made an omission or false statement in his returns of income which resulted in him reporting less tax than he would otherwise have had to pay.

[99] Canada Revenue Agency, *Information Circular* IC 01-1, "Third-Party Civil Penalties," September 18, 2001 at para. 3. For a review of the third-party penalties, see Brian R. Carr and Grace Pereira, "The Defence Against Civil Penalties," (2000) 48(6) Canadian Tax Journal 1137; William I. Innes and Brian J. Burke, "Adviser Penalties: How Will the Courts Construe Section 163.2?," *Report of Proceedings of Fifty-Third Tax Conference,* 2001 Tax Conference (Toronto: Canadian Tax Foundation, 2002) 37:1-38; Bruce S. Russell, "Avoiding Evasion: Tax Advisers' Professional Responsibilities," *Report of Proceedings of Fifty-Sixth Tax Conference*, 2004 Tax Conference (Toronto: Canadian Tax Foundation, 2005) 35:1-10.

[100] *Ibid*, para. 6.

[101] Ibid, para 7 and 9.

- appraisers and valuators preparing a report for a proposed scheme/shelter that could be used by unidentified investors.

…

"Preparer Penalty"

9. Subsection (4), the "preparer penalty," provides for a penalty on a person who makes, or participates in, assents to, or acquiesces in the making of a statement to, by or on behalf of another person that the person knows, or would reasonably be expected to know but for circumstances amounting to culpable conduct, is a false statement that could be used by or on behalf of the other person for a purpose of the ITA/ETA. Despite the name "preparer penalty," it can apply to any person in the aforementioned situation and is not limited to a tax return preparer. Subsection (4) would be applicable to the tax return preparer for each investor or taxpayer that can be identified. Examples would include:

- a person preparing a tax return for a specific taxpayer;
- a person providing tax advice to a specific taxpayer; and
- an appraiser or valuator preparing a report for a specific taxpayer or a number of persons who can be identified.

Third-party penalties may apply to "tax professionals, tax return preparers, accountants, advisors, practitioners, brokers, tax or financial planners, appraisers, valuators, and tax shelter promoters," and "any person … engaged in activities described in paragraphs 7 and 9."[102] This is illustrated in examples 8 and 9 in CRA's *Information Circular* IC 01-1.[103]

CRA's 2002 and 2003 fact sheets indicate that there are a number of penalties that may be applied third parties involved with unacceptable donation tax shelter arrangements, including promoters, appraisers, charities, preparers, advisors, registered charities and registered Canadian amateur athletic associations. CRA indicated that third party penalties can include charities that receive the donation if "it knows – or if it can reasonably be expected to have known – that the appraised values were incorrect." Specifically, it provides as follows:

> Third parties (e.g. promoters, appraisers, charities, preparers.): Effective June 29, 2000, third parties are subject to civil penalties for making misrepresentations in respect of tax matters that could result in their clients making false statements or omissions on their returns which includes overstating the fair market value of a property donated.
>
> These penalties are based on the amount of tax evaded and the gross revenues earned by the third party providing information or services to taxpayers. For more information, see Information Circular 01-1, Third-Party Civil Penalties.
>
> Third Party Penalties can apply to promoters, advisors, charities or other institutions if they knew, or would reasonably be expected to know but for

[102] *Ibid*, para 6.
[103] *Supra* note 99.

> circumstances amounting to culpable conduct, that the appraised values were too high.
>
> Culpable conduct refers to conduct (an act or a failure to act) that is tantamount to intentional conduct, shows an indifference as to whether the *Income Tax Act* or *Excise Tax Act* is complied with, or shows a wilful, a reckless or a wanton disregard of the law.

It is important to note that where the conduct of charities and registered Canadian amateur athletic associations meet the tests set out in subsection 163.2, they may also be subject to third-party penalties.

3. <u>Penalties and other sanctions on tax shelter promoters</u>

Promoters who sell tax shelters before getting a tax shelter number are liable to a penalty equal to the greater of either $500 or 25% of the money received for selling the tax shelter.[104] The same penalty applies for filing false or misleading information on an application for a tax shelter number. No person may claim tax shelter benefits if a promoter is liable for such a penalty or interest on such a penalty.

Subsection 239(2.1) provides that it is a criminal offence to wilfully provide an incorrect identification number for a tax shelter to another person. Upon summary conviction, a person can be sentenced to a fine of not less than 100% and not more than 200% of the cost of the property to the other person, or imprisonment of up to two years, or both the fine and imprisonment.

In addition, other sanctions are also possible. For example, in its fact sheets released in 2002, CRA indicated that it had obtained 10 criminal convictions against tax shelter promoters for tax fraud, resulting in fines of over $9 million and jail terms in all cases.

4. <u>Intermediate sanctions on charities</u>

New intermediate penalties and sanctions for registered charities that do not comply with the requirements of the Act were implemented as a result of the enactment of Bill C-33,[105] which received royal assent on May 13, 2005. These new intermediate penalties and sanctions, set out in section 188.1 of the Act, were proposed in the 2004 federal budget, which recognized that the tax authorities had limited choices available for dealing with charities that commit minor infractions under the Act.[106] Two of the new sanctions relate specifically to improper issuance of

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[104] Subsection 237.1(7.4) of the Act.

[105] Bill C-33, *A Second Act to Implement Certain Provisions of the Budget Tabled in Parliament on March 23, 2004,* i.e. *Budget Implementation Act, 2004, No. 2,* S.C. 2005, c. 19; given royal assent May 13, 2005.

[106] Canada, Department of Finance, 2004 Budget, Notice of Ways and Means Motion to Amend the Income Tax Act, March 23, 2004, resolution 25 and Annex 9, Tax Measures: Supplementary Information. For a summary of the proposals contained in the 2004 federal budget, see Theresa L.M. Man and Terrance S. Carter, "March 2004 Federal Budget Rewrites Tax Rules for Charities" *Charity Law Bulletin* No. 41, March 30, 2004 (online: www.charitylaw.ca).

donation receipts containing incomplete information or false statements by registered charities.

Subsection 188.1(7) of the Act imposes a penalty equal to 5% of the amount reported on an official donation receipt, if the receipt is "otherwise in accordance with [the] Act or the regulations." Pursuant to subsection 188.1(8) of the Act, the penalty upon repeat infractions within five years is increased to 10% of the amount shown on the receipt. The explanatory notes to Bill C-33 indicate that such a penalty would apply to receipts that include incorrect information or receipts that do not contain all of the information required by the Act and the *Income Tax Regulations.* Subsection 188.1(9) of the Act, however, imposes a penalty equal to 125% of the amount shown on a receipt if it contains a false statement.[107]

In *Registered Charity Newsletter* No. 16, CRA pointed out that charities are not obligated to either receive or receipt a gift if they choose not to:

> Charities are reminded that they are not obliged under the *Income Tax Act* to issue official donation receipts for gifts; nor are they required to accept gifts. Before accepting gifts-in-kind, charities should ask themselves how the gift would allow them to further their charitable purposes.

In addition, CRA indicated that "[i]f the charity knew, or would have reasonably been expected to know but for circumstances amounting to culpable conduct, that the valuations were incorrect, it would be liable for the penalties for issuing false receipts."[108]

5. Negative effect on charities' disbursement quota

The disbursement quota is a prescribed amount that registered charities must disburse each year in order to maintain their charitable registration. The purpose of the disbursement quota is "to ensure that most of a charity's funds are used to further its charitable purposes and activities; to discourage charities from accumulating excessive funds; and to keep other expenses at a reasonable level."[109] Part of the disbursement quota requires a charity to expend 80% of all receipted amounts in its immediately preceding taxation year.

CRA's *Registered Charities Newsletter* No. 16 warns that the acceptance of buy-low donate-high in-kind gifts from donors could result in the charity not being able to meet its disbursement quota:

> A charity should not lose sight of the fact that it is the amount for which the

[107] For a review of these two provisions, see Theresa L.M. Man, "Intermediate Penalty for Charities: Improper Donation Receipts," April 20, 2006 (online: www.charitylaw.ca).
[108] Canada Revenue Agency, *Information Circular* IC 01-1, *supra* note 99, commentary to example 8.
[109] See Canada Revenue Agency, *Information Circular* RC 4108, *Registered Charities and the Income Tax Act,* updated May 7, 2002. For a review of the disbursement rules introduced by Bill C-33 in May 2005, see M. Elena Hoffstein and Theresa L.M. Man, "New Disbursement Quota Rules under Bill C-33," paper presented to the Canadian Bar Association/Ontario Bar Association 3rd National Symposium on Charity Law, May 6, 2005 (online: www.charitylaw.ca).

> receipt is issued that is included in its disbursement quota requirement for the following year, even though the charity may in turn sell the property for an amount far below the amount for which the receipt was issued. Failure to meet the disbursement quota is grounds for us to revoke a charity's registered status. In some cases, the charity gambles that the property will be worth at least the receipted amount at some future time.

In an article in *The Globe and Mail* on October 17, 2003, public attention was drawn to this problem with the following statement:[110]

> By law, charities must hand out 80 per cent of the donations they receive. If a charity received a donated piece of art appraised at $1,000, the charity would have to disperse $800 if the piece was sold within 10 years. However, the source [at a major charity] said in many cases organizations get far less than the appraised value for the art and they are forced to meet their disbursement quota through other funds.

Therefore, a charity must be careful to ensure that the eligible amount of a receipt reflects the accurate true value of the donation received in order not to negatively impact the ability of the charity to meet its disbursement quota.

6. <u>Revocation of charitable status</u>

In spite the enactment of intermediate sanctions against registered charities to address minor infractions of the requirement of the Act, such as the two new sanctions referred to above relating to improper issuance of donation receipts, it is still open for CRA to revoke a charity's charitable status for severe breaches of the Act.[111] The same would apply to registered Canadian amateur athletic associations. In addition, failure to meet the disbursement quota may become grounds for losing the charitable status.

Upon revocation, the registered charity must, within one year of its deregistration, either transfer its assets to one or more qualified donees or pay a revocation tax under Part V of the Act, which is a 100% tax on the remaining property of the registered charity (i.e. transferring all of its remaining property to the Crown).

G. Implications of the Proposed Amendments for Charities

1. <u>Too broad and catches unintended bona fide donations</u>

The proposed Deeming Provision and the definition for the "amount of the advantage" are extremely broad in scope. It is conceivable that *bona fide* donations of gifts-in-kind would be caught by the proposed amendments. The Federal Court of Appeal in *Nash* quoted with approval the Tax Court decision in *Klotz,* which was later upheld by the Federal Court of Appeal, that "it

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[110] Paul Waldie, "Art dealer alleges tax harassment," *The Globe and Mail*, October 17, 2003.
[111] Subsection 168(1) of the Act. See also Canada Revenue Agency, *Registered Charities Newsletter* No. 19, June 2004, at 6.

is one thing serendipitously to pick up for $10 a long lost masterpiece at a garage sale and give it to an art gallery and receive a receipt for its true value," and "it is another for Curated to buy thousands of prints for $50, create a market at $300 and then hold out the prospect of a tax write-off on the basis of a $1,000 valuation."[112] Therefore, the court acknowledged that there is a difference between *boda fide* donations of gifts-in-kind with a fair market value much higher than the cost of acquisition and the buy-low donate-high schemes. The latter should be deterred, but not the former. However, the proposed amendments do not differentiate between the two.

Similarly, the inclusion of limited-recourse debt as an advantage may also lead to intended results, e.g. a donor making a cash donation to a charity, with his/her bank directing the donor's cheque to be debited from his/her personal line of credit.[113]

2. Onerous obligations on charities to comply

One of the most surprising new changes released on July 18, 2005, was the introduction of a new subsection 248(40) that would have imposed a heavy onus on charities to make inquiries of donors concerning gifts made on or after January 1, 2006. In particular, a charity issuing a donation tax receipt with a stated eligible amount in excess of $5,000, whether gifts in kind or cash, would have been required to make a "reasonable inquiry" of the donor concerning the existence of any circumstances that would cause the eligible amount to be less than the fair market value of the property.

The charitable sector and its advisors were very concerned with the proposed statutory onus placed on charities when issuing receipts. It was not clear from the proposed changes what type of inquiry would be recognized to be "reasonable." In response to a submission made by the Government Relations Committee of the Canadian Association of Gift Planners, Len Farber of the Department of Finance in a letter dated November 22, 2005, advised that the Department "recognize[s] the difficulties that have been brought to light by this proposal," placing an administrative burden on charities. Mr. Farber indicated that the Department is "prepared to recommend to the Minister of Finance that proposed subsection 248(40) be withdrawn."[114]

While the withdrawal of the proposed statutory onus on charities to make "reasonable inquiry" has been received as a relief to the charitable sector, charities will still have to exercise due diligence when issuing charitable donation receipts to ensure that the information on the receipts is accurate. In this regard, Mr. Farber stated in his letter that "charities will still be responsible to seek relevant information from donors where the need for such information is apparent to them in the particular circumstances." Failure to issue receipts reflecting the accurate

[112] *Nash*, *Supra* note 86, at para 35.
[113] Boyle, supra note 38, at 7:24.
[114] Canada, Department of Finance, Letter to Canadian Association of Gift Planners, November 22, 2005.

eligible amounts may lead to charities being exposed to intermediate sanctions for issuing incomplete receipts or false receipts or may even lead to the revocation of their charitable status.

Subsection 248(41) provides that if a donor fails to provide the above mentioned information to the charity, then the eligible amount of the gift would be deemed to be nil. Since the charity is required under subsection 248(40) to make inquiries of donors for such information, subsection 248(41) would apply whether or not the charity has made the required inquiries. In other words, if the charity has not made the required inquiries in issuing the donation receipt, the eligible amount would be deemed to be nil and the charity may be subject to the penalties and sanctions mentioned above. However, if the charity has made the necessary inquiries but was not advised by the donor of the relevant information, then the eligible amount would still be deemed to be nil and it is hoped that it would be open for the charity to argue that it should not be subject to the sanctions and penalties, and that the exposure to such would rest solely with the donor. Depending on the factual situation involved, such charities may also run the risk of facing legal action by disgruntled donors.

It is not clear what level of inquires is required to be made by charities to seek information.[115] However, due to the broad scope of the proposed amendments as explained above, from a practical standpoint, this would be a difficult if not impossible task for charities to inquire of donors of the circumstances surrounding the donations. Examples of inquiries would include:

- whether a gifted property was acquired through a gifting arrangement;
- whether a gifted property was acquired by the donor or any person dealing at non-arm's length with the donor within the last 3 years and, if so, what the lowest cost to the donor or any person dealing at non-arm's length was;
- whether a gifted property was acquired by the donor or any person dealing at non-arm's length with the donor within the last 10 years, whether it is reasonable to conclude that one of the main reasons for acquiring the property was to make a gift and, if so, what the lowest cost to the donor or any person dealing at non-arm's length was;
- whether the debtor incurred a limited-recourse debt related to the gift;
- whether a limited-recourse debt is repaid pursuant to subsection 248(34);
- whether the donor received any other advantage that is in any way related to the gift.

It would seem unreasonable to put the burden on charities to inquire into the personal

[115] See for example Theresa L.M. Man, "Inquiries Still Required When Charities Issue Donation Receipts," *Charity Law Bulletin* No. 83, January 11, 2006 and Hoffstein, Man and West, *supra* note 16.

affairs of donors and the advantages related to the gift that are provided by third parties when issuing receipts. It would seem unfair to require charities to "police" the compliance of the Act by their donors by using their already limited resources in this additional administrative function. The Joint Committee on Taxation has recommended to Finance that a charity only be required to report the amount of advantages that it provided or that it knows a third party has provided if the charity knew or reasonably ought to have known (i.e. wilful blindness).[116] However, the recommendation has not been acted upon by Finance.

It has been suggested that it would seem better to have the burden of compliance to rest on the donors, who, afterall, are the ones receiving the tax benefits. Thus, charities would be responsible for ensuring that the receipts they issue reflect the fair market value of the property they received, as they are required to do so under current law. Donors would be required to provide information in their income tax returns regarding when the property was acquired and the cost of acquisition, whether the property was acquired through a gifting arrangement, whether there is any advantage received in respect of the gifts made, whether the donor incurred any limited-recourse debt, etc.[117] This would leave the donors responsible for compliance with the Act in respect of unacceptable donation tax shelter schemes and relieve charities from incurring additional administrative costs in order to comply with the proposed requirements.

The level of inquiries to be made by charities to seek information will depend on the circumstances. It may be that the best approach to be taken by charities is to develop and implement a gift receipting policy conforming to the highest standard in the circumstances, such as a questionnaire for donors to complete and possibly requiring donors to provide sworn statements under certain circumstances. It is important for charities to advise donors that donation receipts will be issued in compliance with the requirements under the Act and that only the eligible amount of the gift, not the full value of the donation given, will be stated in the donation receipt for tax deduction purposes by the donors.

Charities will need to have a working knowledge of the proposed split-receipting and tax shelter rules in order that they may know when to "seek relevant information from donors where the need for such information is apparent to [the charities] in the particular circumstances," and what information to seek in this regard. Having such an understanding is not limited to accounting staff and senior management of charities, but also staff that may be in contact with potential donors, such as fundraising and gift planning staff, as well as staff involved in

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[116] Recommendation G.2 of the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institution of Chartered Accountants, May 6, 2003, submission to the Department of Finance Re: Issues for Consideration December 20, 2002 Technical Amendments General Provisions.
[117] DePetris, *supra* note 12, at 5B:16.

promotion and marketing, since they will be preparing publication and promotional materials for charities that may induce donations from donors.

In addition, it should be noted that this due diligence must always take place before the charity issues a receipt to the donor for the gift and not retrospectively; it must be made regardless of the type of donated property (i.e. cash or gifts in kind); and it must be made whether or not the donor is forthcoming with information regarding these issues. Charitable staff must be educated to these issues and thoroughly document all written and verbal correspondence with donors concerning these matters.

H. Conclusion

At this time, the proposed changes to the Act are still in draft form. It is not clear whether further changes will be made to these proposals and when a draft bill will be introduced in Parliament. However, investors and charities must be aware that these proposals, if and when enacted, will become retroactive, and compliance at this time with these proposed amendments are expected. Given the numerous warnings by CRA in relation to unacceptable donation tax shelters, investors and charities should be extremely cautious before becoming involved in any donation tax shelter program that promises results to the donor or the charity that seem too good to be true, because they probably are.