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# COMMENTARY ON DRAFT TECHNICAL AMENDMENTS TO THE *INCOME TAX ACT* RELEASED ON DECEMBER 20, 2002 THAT AFFECT CHARITIES

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## A. INTRODUCTION

On December 20, 2002, a package of draft technical amendments to the *Income Tax Act* (the "Act") was released, amending numerous provisions of the Act (the "December 2002 Amendments"), a number of which affect charities. Canada Customs and Revenue Agency ("CCRA") indicated on its website on December 24, 2002 that the December 2002 Amendments will affect charities in the following ways:

- "More transparency for registered Canadian amateur athletic associations;
- Clarification that a registered charity cannot disburse funds to an organization that is not a qualified donee, even after meeting its disbursement quota;
- Changes to the definitions of a charitable organization and a public foundation, in such a way that designation as a private foundation is now more limited; and
- Changes that 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")."

This *Charity Law Bulletin* provides a brief explanation of those amendments and their impact on charities.

## B. DEFINITION OF CHARITABLE ORGANIZATION AND PUBLIC FOUNDATION

Under the December 2002 Amendments, the definitions of charitable organizations and public foundations are amended by replacing the "contribution" test with a "control" test. According to the Explanatory Notes released by the Department of Finance that accompanied the December 2002 Amendments (the "Explanatory Notes"), the rationale for amending the definitions is to permit charitable organizations and public foundations to receive large gifts from donors without concern that they may be deemed to be a private foundation.

Under the current provisions of the Act, two of the criteria that both charitable organizations and public foundations are required to comply with include the following: (1) not more than 50% of its directors, trustees, officers or like officials can deal with each other and with each of the other directors, trustees, officers or officials at arm's length, and (2) not more than 50% of the capital contributed or otherwise paid to the charity can be contributed by one person or members of a group of such persons who do not deal with each other at arm's length. The second requirement is usually referred to as a "contribution" test. Contributions received from some sources are excepted, including the federal government, a provincial government, a municipality, another registered charity that is not a private foundation, and a club, society, or association that is a non-profit organization under paragraph 149(1)(l) of the Act. The purpose of the exception is to permit charitable organizations and public foundations to receive large gifts from these excepted entities.

However, under the current definitions, charitable organizations and public foundations are not permitted to receive large gifts from other entities. As a result of inquiries from the public, the Department of Finance decided to amend the definition of both charitable organizations and public foundations to "*ensure that in certain circumstances large donations are not prohibited.*" This is achieved by replacing the "contribution" test with a "control" test. The Explanatory Notes indicate that as a result of the amendments to the definitions of charitable organizations and public foundations in subsection 149.1(1) of the Act, charitable organizations or public foundations will not be disqualified "*solely because a person, or a group of persons not dealing with each other at arm's length, has contributed more than 50% of the charity's capital*." However, "*such a person or group is not permitted to control the charity in any way, nor may the person or*

*the members of the group represent more than 50% of the directors, trustees, officers and similar officials of the charity.*"

Specifically, the current requirement that more than 50% of the directors, trustees, officers or like officials of the foundation must deal at arm's length with each other and with each of the other directors, trustees, officers or officials of the charity is retained in the December 2002 Amendments. In addition, more than 50% of the directors, trustees, officers or like officials of the charity are also required to deal at arm's length with (i) "*each person,*" and (ii) "*each member of a group of persons who do not deal with each other at arm's length,*" who has contributed more than 50% of the capital of the charity, "*other than Her Majesty in right of Canada or of a province, a municipality, another registered charity that is not a private foundation, and any club, association described in paragraph 149(1)(l)*" of the Act.

Furthermore, the "contribution" test requiring not more than 50% of the capital of the charity be contributed by one person or members of a group of such persons who do not deal with each other at arm's length is replaced by a "control test" which requires that the charity "*is not, and would not be if the organization* [or foundation] *were a corporation, controlled directly or indirectly in any manner whatever (i) by a person that has contributed or otherwise paid into the organization* [or foundation] *more than 50% of the capital of the organization, (other than Her Majesty in right of Canada or of a province, a municipality, another registered charity that is not a private foundation, and any club, association described in paragraph 149(1)(l)), or (ii) by a group of persons that do not deal at arm's length with each other, if any any member of the group does not deal at arm's length with a person described in subparagraph (i).*" [emphasis added]

In general, this new definition is retroactively applicable to January 1, 2000. Those registered charities that wish to apply under subsection 149.1(6.3) to change their designation as a result of the amendments described above are required to apply within 90 days after the December 2002 Amendments having received Royal Assent and these registered charities will be deemed to be registered as charitable organizations, public foundations, or private foundations, as the case may be, in the taxation year that the Minister of National Revenue specifies.

As a result of the introduction of a "control" test, the intricate corporate rules in relation to "control" will become applicable as a result of the phrase "*controlled directly or indirectly in any manner whatever"* contained in the new definition. Subsection 256(5.1) of the Act states that "*for the purposes of this Act, where the expression 'controlled, directly or indirectly in any manner whatever,' is used, a corporation shall be considered to be so controlled by another corporation, person or group of persons (in this subsection referred to as the 'controller') at any time where, at that time, the controller has any direct or indirect influence that, if exercised, would result in control in fact of the corporation, except that, where the corporation and the controller are dealing with each other at arm's length and the influence is derived from a franchise, license, lease, distribution, supply for management agreement or other similar agreement or arrangement, the main purpose of which is to govern the relationship between the corporation and the controller regarding the manner in which a business carried on by the corporation is to be conducted, directly or indirectly in any manner whatever, by the controller by reason only of that agreement or management.* " [emphasis added] This concept of "de facto control" is further explained in Interpretation Bulletin IT-64R.

However, the application of the rules concerning "control" in the charitable context would appear unclear, since these rules are premised upon application to commercial arrangements in the business context rather than for charitable corporations. As such, for charity law practitioners, these rules will need to be carefully reviewed when establishing charitable organizations and public foundations, especially in the case of establishing a multiple corporate structure, in order to ensure that the charities in question will not inadvertently be caught by these rules that might otherwise lead to undesirable or unintended results. As well, the current corporate structure of registered charities will need to be reviewed in order to assess whether these new provisions are applicable.

### C. A NEW CONCEPT OF "GIFT" FOR TAX PURPOSES

The December 2002 Amendments introduced a new concept of "gift" for tax purposes which is different from the traditional concept of "gift" at common law by the insertion of subsection 248(30), (31), (32) and (33) to the Act, which will apply to gifts made after December 20, 2002.

At common law, in order to have a valid gift, three elements are required: (1) the donor must have an intention to give, (2) there must be successful delivery of the gift from the donor to the donee, and (3) the gift must be accepted by the donee. The Explanatory Notes to the December 2002 Amendments state that, at common law, property must be transferred voluntarily, without any contractual obligation and with no advantage of a material character returned to the donor and that, as such, a contract to dispose of a property to a charity at a price below fair market value would not generally be considered to include a gift. However, the new subsections 248(30) to (33) of the Act will create a new concept of "gift" for tax purposes which will permit a donor to have a tax benefit under the Act even though the donor (or a person not dealing at arm's length with the donor) received a benefit, provided that the value of the property exceeds the benefit received by the donor.

It would appear from the Explanatory Notes that the rationale for the more lenient treatment of gifts compared to that of the long-established rules at common law is an attempt by CCRA to offer a benefit to donors of gifts that are permitted under section 1806 of the *Civil Code of Quebec*, whereby it is possible to sell property to a charity at a price below fair market value, resulting in a gift of the difference. This is based on the rule that a gift in Quebec is a contract by which ownership of property is transferred by gratuitous title. In order to achieve this result, CCRA appears to have accepted a line of caselaw at common law whereby the courts have accepted transfers of property to a charity where the transfer was made partly in consideration for services and partly as a gift.

The new subsection 248(30) of the Act defines the "*eligible amount of a gift*" to be "*the amount by which the fair market value of the property that is the subject of the gift exceeds the amount of the advantage, if any, in respect of the gift.*" The "*amount of the advantage*" in respect of a gift or political contribution is defined in subsection 248(31). The "*amount of the advantage in respect of a gift or a contribution*" by a donor is in general defined as the total of all amounts, "*at the time the gift or contribution. is made*" of any "*property, service, compensation or other benefit*" that the donor or a person not dealing at arm's length with the donor "*has received or obtained or is entitled, either immediately or in the future and either absolutely or contingently, to receive or to obtain as partial consideration for, or in gratitude for, the gift or contribution.*" As such, the advantage has the following characteristics:

- The value of the advantage is the total value of any "*property, service, compensation or other benefit*" in question;
- The timing for valuation of the amount of the advantage is at the time when the gift is made;
- The advantage could be received, obtained, or entitled to by either (a) the donor or (b) a person not dealing at arm's length with the donor;
- The advantage may be either (a) received immediately or to be received in the future, (2) to be received by the donor absolutely or contingently, or (3) to be received by the donor as partial consideration for or in gratitude for the gift received by the charity.

New subsection 248(33) of the Act provides that the cost to the donor of property which is the subject of the gift is the fair market value of the property at the time of the making of the gift.

The Explanatory Notes states that "*for the transfer of property to qualify as a gift, it is necessary that the transfer be voluntary and with the intention to make a gift.*" At common law, where the donor of the property has received any form of consideration or benefit, it is generally presumed that such an intention is not present. The new subsection 248(32) of the Act permits this presumption at common law to be "rebutted." Subsection 248(32)(a) provides that if the amount of the advantage does not exceed 80% of the fair market value of the transferred property, then the existence of an amount of an advantage to the donor will not necessarily disqualify the transfer from being a gift. Where the amount of an advantage exceeds 80% of the fair market value of the transferred property, subsection 248(32)(b) provides that the donor can establish to the satisfaction of the Minister of National Revenue that the transfer was made with the intention to make a gift. The Explanatory Notes give the example that where a donor transfers land and a building with a fair market value of $300,000 to a charity, which would assume the liability of $100,000 under the mortgage. As such, the eligible amount of the gift that the donor is entitled to is $200,000. If the outstanding mortgage liability is over 80% of $300,000, i.e. over $240,000, the donor could apply to CCRA for a determination of whether the donor has an intention to make a gift.

As a result of the December 2002 Amendments in relation to the concept of "gift" under the Act, a number of related provisions of the Act and the Regulations are also proposed to be amended, such as subsections 110.1(1) and 11.8(1) of the Act concerning charitable donations deduction and charitable donations tax credit; subsections 35011(1), (1.1), and (6) and subsections 2000(1) and (6) of the Regulations concerning official donation receipts; as well as subsection 149.1(1) of the Act concerning the definition of "disbursement

quota." It would appear that this new concept of "gift" would encourage donations to the charitable sector. However, the precise impact of the application of this concept of "gift" remains to be seen. In addition, CCRA has begun to change a number of its administrative policies as a result of the proposed amendments, such as the following:

- CCRA released Income Tax Technical News No. 26 on December 24, 2002, which proposed a new set of guidelines on split-receipting, which explains CCRA's administrative policy in relation to various situations, including new rules concerning charitable gift annuities; and
- The new concept of "gift" is relied upon in two policy commentaries released by CCRA on February 26, 2003 to clarify CCRA's policy regarding expenses incurred by volunteers on behalf of a registered charity, and CCRA's policy regarding fundraising events for the benefits of a particular registered charity.

These new changes will be summarized in a future Charity Law Bulletin.

## D. REVOCATION OF REGISTRATION OF CHARITIES

Subsection 149.1(2), (3), and (4) of the Act provide for circumstances under which the charitable status of a charity may be revoked. Pursuant to the December 2002 Amendments, subsection 149.1(2), (3), and (4) are amended to permit the revocation of the charitable status of charitable organizations, public foundations, and private foundations if such entities "*make a disbursement by way of a gift*" which is not a gift made "*in the course of charitable activities carried on by it*" or not a gift "*to a donee that is a qualified donee*" at the time of the gift. As such, all gifts made by a charity must be made in the course of furthering its charitable activities. Any gifts made by a charity to a non-qualified donee would be cause for revocation of the charitable status of the charity. This would apply even though the charity has met the applicable disbursement quota. After Royal Assent, these amendments would apply to gifts made by charities after December 20, 2002.

As a result of the serious consequences in making a disbursement which is not permitted under these subsections, charities will need to be more cautious than ever when making disbursements by ensuring that all disbursements are made in the course of carrying out their charitable activities and none of the disbursements are made to non-qualified donees, unless there is an agency, joint venture or partnership agreement in place that is acceptable to CCRA.

## E. EXPANDED PUBLIC INFORMATION

Paragraph 149.1(15)(b) currently permits the Minister to make available to the public certain information concerning registered charities, including a list of all registered charities, indicating their names, location, registration number, date of registration, and effective date of revocation of charitable status where applicable. Pursuant to the December 2002 Amendments, this authority to disclose information to the public is expanded to apply to Canadian Amateur Athletic Association in order to provide more transparency to the operations of these entities to the public.

## F. CONCLUDING COMMENTS

In general, the December 2002 Amendments bring about a number of important changes that will be of major significance to charities. However, the application of some of these new changes are unclear at this time, and it is important for charity law practitioners, executive directors of charities, and members of their respective boards to review these amendments carefully in order to ensure compliance with the amendments, and particularly compliance with the new control test as well as the new definition of "gift."

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