
DECEMBER 5, 2003 *INCOME TAX ACT* AMENDMENTS AFFECTING CHARITIES

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A. INTRODUCTION

Since December 2002, the Department of Finance (the “Department”) and Canada Revenue Agency (formerly Canada Customs and Revenue Agency¹) (“CRA”) have released a series of proposed changes to the *Income Tax Act* (the “Act”) that affect charities. These proposed changes include (1) the December 20, 2002 draft technical amendments to the Act (the “December 2002 Amendments”)², (2) the December 24, 2002 Income Tax Technical News No. 26 (“Technical News No. 26”) in relation to new guidelines on split-receipting³, and (3) the 2003 federal Budget (released on February 28, 2003) (the “February 2003 Budget”) expanding the definition of “tax shelter” to include “gifting arrangements.”⁴ The proposals brought by the February 2003 Budget were introduced into the House of Commons via Bill-C28: *An Act to implement certain provisions of the budget tabled in Parliament on February 18, 2003*, which was passed into law on June 19, 2003. The 2002 Amendments, however, have not yet been passed by Parliament.

¹ On December 12, 2003, Canada Customs and Revenue Agency changed its name to Canada Revenue Agency. The customs program is now part of the new Canada Border Services Agency (CBSA). See the announcement on CRA’s website at <http://www.ccradrc.gc.ca/agency/namechange-e.html>.

² Details regarding the December 2002 Amendments have been summarized in *Charity Law Bulletin* No. 21 dated April 30, 2003, which can be accessed at our website at <http://www.carters.ca/pub/bulletin/charity/2003/chylb21.pdf>.

³ Details regarding the Technical News No. 26 have been summarized in *Charity Law Bulletin* No. 23 dated July 31, 2003, which can be accessed at our website at <http://www.carters.ca/pub/bulletin/charity/2003/chylb23.pdf>.

⁴ The portion of the 2003 Budget concerning tax shelter donation schemes involving donors donating property to charities at a value in excess of the donors’ acquisition cost was briefly commented upon in *Charity Law Bulletin* No. 30 dated December 16, 2003, which can be accessed at our website at <http://www.carters.ca/pub/bulletin/charity/2003/chylb30.pdf>. Details concerning tax shelter donation schemes are contained in this *Charity Law Bulletin*.

Following this series of proposed changes to the Act, the Department again released proposed amendments to provisions of the Act on Friday, December 5, 2003 (the “December 2003 Amendments”) at 6:00 p.m. (the “Announcement Time”) that have the effect of curtailing tax shelter donation programs involving the donation of property, restricting the use of limited-recourse debts as tax shelters, and further amending proposals put forward in the December 2002 Amendments. The proposed changes contained in the December 2003 Amendments that affect charities are summarized in this *Bulletin*.

B. CURTAILING TAX SHELTER DONATION SCHEMES INVOLVING DONATION OF PROPERTY

In the news release that accompanied the December 2003 Amendments, the Department indicated that the proposed amendments were in response to concerns that “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.” “Tax shelter” is in general any property in respect of which it is represented that a potential purchaser will be able to claim, within four years, deductions from income or taxable income which equal or exceed the net cost of the property to the purchaser. The February 2003 Budget expanded the definition of “tax shelter” in section 237.1(1) of the Act to apply to property acquired by a person under a gifting arrangement in respect of which it is represented that the acquisition of the property would generate any combination of tax credits or deductions that in total would equal or exceed the cost of acquiring the property in question, and that the property acquired will be the subject of a gift to a qualified donee or of a political contribution.

The background and rationale regarding the concern of the Department and the CRA to curtail tax shelter donation schemes have been summarized in *Charity Law Bulletin* No. 30 dated December 16, 2003.⁵ In order to achieve this objective, the December 2003 Amendments propose to insert a new subsection 248(35) in the Act, of which subparagraph (a) provides that if the taxpayer acquires the property through a “gifting arrangement” as defined in section 237.1 of the Act described above, then the fair market value of the property donated, for purposes of the charitable donation receipt issued by the receipting charities, shall be “deemed” to be the lesser of (i) the “fair market value of the property otherwise determined” and (ii) the cost

⁵ See footnote 4 above.

(or the adjusted cost base in the case of capital property) of the property “to the taxpayer immediately before the gift is made” (the “Deeming Provision”). As such, it is irrelevant when the property was acquired by the donor through the gifting arrangement.

In introducing the Deeming Provision for donation of property acquired through gifting arrangements, the Department went further than simply curtailing the tax shelter donation schemes addressed by paragraph 248(35)(a). The Department further introduced paragraph 248(35)(b) to provide that the Deeming Provision also applies to donation of property under two other situations, namely, (1) pursuant to subparagraph 248(35)(b)(i), if the property was acquired by the donor less than three years before the day that the gift is made, and (2) pursuant to subparagraph 248(35)(b)(ii), if it is “reasonable to conclude that, at the time the taxpayer acquired the property, the taxpayer expected to make a gift of the property.” Under the former scenario, if a donor acquires property and donates the property within three years from the date of acquisition, then the fair market value of the property shall be deemed to be the donor’s cost or adjusted cost base. Under the latter scenario, regardless of when the donor acquired the property (even outside of the three-year limitation period), as long as it is “reasonable to conclude” that the donor had the intention to make a gift at the time when the property was acquired, then the Deeming Provision would apply. The burden is on the donor to prove that he or she did not have an intention to make a gift when the property was acquired.

The new Deeming Provision, however, pursuant to a new subsection 248(36), does not apply to inventory, real property situated in Canada, certified cultural property, publicly traded shares, or ecological gifts. As well, the opening wording of paragraph 248(35)(b) provides that the Deeming Provision does not apply to situations where the gift is made as a consequence of the donor’s death. Subsections 248(35) and (36) apply to gifts made on or after the Announcement Time.

C. RESTRICTING THE USE OF TAX SHELTER DONATIONS INVOLVING LIMITED-RECOURSE DEBTS

In addition to the donation of property to charities under the gifting arrangements of tax shelter donation schemes, another type of gifting arrangement which the Department felt the need to restrict involves limited-recourse debts incurred by donors (also known as “leveraged loans” or “leveraged donation shelters”). This usually involves a donor borrowing monies from a lender, followed by the donor donating the borrowed fund

together with some of his or her own funds to a charity in return for a charitable donation receipt for the cumulative amount donated. At the same time, the donor pays a fee or other charges to the promoter, which fee or charges would be used to purchase property or to be invested for a return that would, over the term of the loan, be sufficient to pay off the loan borrowed.

The February 2003 Budget, in expanding the definition of “tax shelter” in section 237.1(1) of the Act to include property acquired under a gifting arrangement, also expanded the definition of “tax shelter” to include a gifting arrangement under which it may reasonably be expected, having regard to representations made, that if a taxpayer makes a gift or contribution under the arrangement, a person (whether or not it is the taxpayer himself or herself) will incur an indebtedness in respect of which recourse is limited.

The December 2003 Amendments propose to curtail the use of these arrangements by introducing a series of amendments to the Act, including the insertion of new subsection 143.2(6.1) to the Act, the amendment of the wording of subsection 143.2(13) before paragraph (a), the insertion of new paragraph (b) to subsection 248(31) that was introduced by the December 2002 Amendments⁶, as well as the insertion of new subsection 248(34) to the Act. These amendments only apply to donations made after February 18, 2003. A summary of the amendments follows.

The proposed paragraph 248(31)(b) of the Act provides that the amount of gift made by the donor would be reduced by the amount of the limited-recourse debt incurred as determined pursuant to the newly proposed subsection 143.2(6.1). Subsection 143.2(6.1) of the Act introduces a new definition of “limited-recourse debt” which has two aspects. Firstly, pursuant to paragraphs 143.2(6.1)(a) and (b), a “limited-recourse debt” is a limited-recourse amount, which is defined under section 143.2(1) to mean “the unpaid balance of any indebtedness for which recourse is limited, either immediately or in the future and either absolutely or contingently,” that can “reasonably be considered to relate to the gift.” In situations where recourse is not limited, the debt may be “deemed” to be a limited-recourse debt under the current subsection 143.2(7) of the Act unless there are bona fide arrangements in writing to repay the debt within 10 years, and interest is paid annually, within 60 days after the debtor’s taxation year, at not less than CRA’s prescribed rate. Secondly, pursuant to paragraph 143.2(6.1)(c), a “limited-recourse debt” means any indebtedness, whether or not

⁶ See Charity Law Bulletin No. 21 dated April 30, 2003 referred to note 2 above.

recourse is limited, that can “reasonably be considered to relate to the gift,” for which there is a “guarantee, security or similar indemnity or covenant” in respect to that debt or any other debts.

The cumulative effect of paragraph 248(31)(b) and subsection 143.2(6.1) is to reduce the amount of the gift made by the donor by the amount of the loan borrowed 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 December 2003 Amendments also proposed the addition of subsection 248(34) to the Act that would deem repayments of the limited-recourse debt as gifts in the year it is repaid. Lastly, subsection 143.1(13) is amended so that it is applicable to gifts and monetary contributions by including references to “gift or monetary contribution” in this subsection.

D. ADVANTAGE TO DONORS

The December 2002 Amendments introduced a new concept of “gift” for tax purposes that is different from the traditional concept of “gift” at common law by introducing subsections 248(30), (31), (32), and (33) to the Act. Details regarding these amendments have been set out in *Charity Law Bulletin* No. 21 dated April 20, 2003.⁷ As well, the relationship between these proposed sections of the Act and the guidelines on split-receipting introduced by CRA in Technical News No. 26 has been summarized in *Charity Law Bulletin* No. 23 dated July 31, 2003.⁸ Readers are encouraged to refer to these *Charity Law Bulletins* for details. The December 2003 Amendments brought further amendments to these subsections as follows:

- a) 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 gift exceeds the amount of the advantage in respect of the gift. The December 2003 Amendments clarified that subsection 248(30) is also applicable to monetary contributions made to registered parties and candidates by including additional references to “monetary contributions” in this subsection, as well as by cross referencing the term “eligible amount” in subsection 127(3) of the Act which provides that monetary contributions to registered parties and candidates may be deducted from tax. This subsection applies to gifts made after December 20, 2002.

The wording in subsection 248(31) introduced by the December 2002 Amendments, defining the “amount of advantage” that would not be considered as part of the “eligible amount” of a gift, has been substantially amended by the December 2003 Amendments.

⁷ See note 2 above.

⁸ See note 3 above.

The original wording introduced by the December 2002 Amendments became subsection 248(31)(a) by the insertion of a new subsection 248(31)(b) which requires the reduction of the amount of a gift by the limited-recourse debt incurred by the donor as explained above.

- b) The wordings in subparagraph 248(31)(a) have been substantially altered. The original wording introduced by the December 2002 Amendments defined the “amount of the advantage in respect of a gift or a contribution” to generally be 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.” Subparagraph (a) now provides that the amount of advantage includes the value, at the time when the gift is made, of “any property, service, compensation or other benefit” that the donor, “a person or partnership who does not deal at arm’s length” with the donor, or “another person or partnership who deals at arm’s length with and holds, directly or indirectly, an interest in the taxpayer” [i.e. the donor], 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 the gift, (ii) in gratitude of the gift, or (iii) in “any other way related to the gift.” (For ease of reference, changes to the original wordings have been underlined in the foregoing sentence.)

When compared to the original wordings, the December 2003 Amendments have proposed the following changes to subparagraph 248(a):

- i) The advantage, in the form of “property, service, compensation or other benefit” has been expanded from an advantage benefiting the donor or a person who does not deal at arm’s length with the donor to also include an advantage that benefits a “partnership who does not deal at arm’s length” with the donor, and an advantage that benefits “another person or partnership who deals at arm’s length with and holds, directly or indirectly, an interest” in the donor.
- ii) The definition of advantage, in addition to being one the donor has “received or obtained or is entitled to receive,” has been expanded to include an advantage that could be “enjoyed” by the donor.
- iii) The advantage, in addition to being in consideration for or in gratitude of the gift, has been expanded to include an advantage that is in “any other way related to the gift.”

Subsection 248(31)(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” in subparagraph 248(31)(a)(iii) applies to gifts made on or after the Announcement Time.

- c) Subsection 248(32) that was introduced by the December 2002 Amendments remains the same, save and except the insertion of a clarification that the gifts in question are gifts made to “qualified donees.” This subsection applies to gifts made after December 20, 2002.

- d) Subsection 248(33) that was introduced by the December 2002 Amendments also remains the same, save and except the insertion of a clarification that this subsection also applies to monetary contributions made to registered parties and candidates by including references to “monetary contributions” in this subsection. This subsection also applies to gifts made after December 20, 2002.

E. ANTI-AVOIDANCE RULES

Finally, the December 2003 Amendments introduced an anti-avoidance rule in the new subsection 248(37) of the Act which states that if “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 for the purpose of subsection 248(35) shall be deemed to be the lowest cost to the donor to acquire the property in question or “an identical property at any time.” This subsection applies to gifts made on or after the Announcement Time.

F. PRACTICAL IMPLICATIONS

The changes brought by the December 2003 Amendments to curtail tax shelter donation schemes was necessary because of the abuse that was occurring involving both donors and charities that were unintentionally enticed to participate in tax shelter donation schemes. In the future, charities and their boards of directors will need to be cautious before becoming involved in any donation program that promises results to the donor or the charity that seem too good to be true, because they probably are.

The application of the proposed Deeming Provision to gifts made outside of tax shelter donation arrangements under paragraph 248(35)(b)(i) of the Act, if the December 2003 Amendments are passed, will also have practical implications on how charities need to operate in terms of acceptance of gifts and the issuance of charitable donation receipts.

Firstly, charities will be required to inquire of donors of gifts-in-kind when the property donated was acquired by the donors. Where possible, a written confirmation will need to be obtained from the donors in this regard to evidence the date of acquisition. Where property was acquired by the donors less than three years before the date of donation, the charitable donation receipt will need to reflect the deemed fair market value of the property, being the lesser of the appraised fair market value and the cost of acquisition by the donor. Where

property was acquired by the donors more than three years before the date of the donation, then the charitable donation receipt will need to reflect the appraised fair market value of the property.

Secondly, although the burden is on the donors to prove the lack of intention to make a gift when the property was acquired, it raises a concern whether charities will be required to inquire of donors of gifts-in-kind to determine whether the donor had the intention to make a gift at the time when the donor acquired the property, regardless of when the property was acquired. On the one hand, without charities making the necessary inquiries, it is unclear what value should be reflected in the charitable donation receipt that the charities are required to issue to the donor. On the other hand, since charities are obviously grateful to receive donations, it will be difficult for charities to make such inquiries of its donors regarding whether they had any intention to make a gift when the property was acquired.

Thirdly, there is the possibility that the Deeming Provision could lead to unintended negative results, such as catching the donation of privately held shares where the donor exchanged the original shares for shares of another class for the purpose of donating them to a charity. As such, hopefully the wording of the Deeming Provision in the December 2003 Amendments will be amended before being passed into law to address the unintended results.

In addition to the implications brought about by the proposed Deeming Provision, the proposed amendments to the definition of advantage in subsection 248(31) of the Act also has serious practical concerns for charities. The expansion of the definition of “advantage” in subsection 248(31) of the Act to include an advantage that is “in any other way related to the gift” has broad applications. Technically, the advantage can be received prior to, at the same time as, or subsequent to the making of the gift by the donor. As well, it is not 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. Therefore, as pointed out by Robert Kepes in his article “Charitable Donation Tax Shelters: Legislative Tax Planning or Tax Porn”⁹, “it makes no difference if a donor makes a gift of cash in consideration of the charity employing his spouse in the future, or if the charity hires the spouse in gratitude of the gift being made in the future.” Under those situations, the charity will need to determine the value of the advantage “at the time the gift is made” and the eligible amount of the

⁹ Robert Kepes, “Charitable Donation Tax Shelters: Legitimate Tax Planning or Tax Porn?” (January 2, 2004) 1660 Tax Topics 1, at 4.

gift will need to be reduced by the value of the “advantage” received by the donor’s spouse in being employed by the charity.

Furthermore, subsection 248(31) continues to be silent on the issue from whom the advantage may be provided. Presumably, it would also include advantages provided by third parties, even unbeknownst to the charity issuing the charitable donation receipt. The difficulty is that the charity in question may not be aware of advantages provided to donors by third parties. As a result, charities will need to make inquiries of all donors whether they have “received, obtained or enjoyed, or [are] entitled . . . to receive” a benefit “either immediately or in the future and either absolutely or contingently” from anyone. This information is expected to be difficult for the charity to acquire.

G. CONCLUSIONS

In conclusion, if the December 2003 Amendments are passed into law, the amendments will have serious practical implications on the way that charities may accept gifts and issue charitable donation receipts. It is important that charities familiarize themselves with the provisions contained in the December 2002 Amendments, the Technical New No. 26, the February 2003 Budget, and the December 2003 Amendments, and proactively develop a gift acceptance policy and implement the necessary procedures to address the various changes introduced by the wave of legislative changes brought by the Department and the administrative procedures adopted by CRA.