

## **FEBRUARY 27, 2004, REVISED DRAFT AMENDMENTS TO THE *INCOME TAX ACT* AFFECTING CHARITIES**

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### **A. INTRODUCTION**

On February 27, 2004, the Department of Finance (the “Department”) released Revised Draft Technical Amendments to the *Income Tax Act* (the “Act”) (the “February 2004 Amendments”) that will impact how charities operate. Only those proposed amendments that affect charities are summarized in this article. The February 2004 Amendments constitute a consolidation of and further amendment to previously proposed technical amendments introduced by the Department on December 20, 2002 (the “December 2002 Amendments”)<sup>1</sup> and on December 5, 2003 (the “December 2003 Amendments”)<sup>2</sup> at 6 p.m.. The effect of these changes on the December 2002 Amendments and December 2003 Amendments have also been summarized in greater detail in an article by the authors entitled “Recent Changes to the *Income Tax Act* and Policies Relating to Charities and Charitable Gifts.”<sup>3</sup> Readers are encouraged to refer to that paper for a more detailed discussion.

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<sup>1</sup>Details regarding the December 2002 Amendments have been summarized in *Charity Law Bulletin* No. 21 dated April 30, 2003, which is available on our website at [www.charitylawbulletin.ca/2003/chylb21.pdf](http://www.charitylawbulletin.ca/2003/chylb21.pdf).

<sup>2</sup>Details regarding the December 2003 Amendments have been summarized in *Charity Law Bulletin* No. 30, dated December 16, 2003, and *Charity Law Bulletin* No. 38 dated February 19, 2004, which are available on our website at [www.charitylawbulletin.ca](http://www.charitylawbulletin.ca).

<sup>3</sup>The paper “Recent Changes to the *Income Tax Act* and Policies Relating to Charities and Charitable Gifts (Current to March 1, 2004)” was presented to the Society of Trust and Estate Practitioners and is available at [www.carters.ca/pub/article/charity/2004/tsc0304.pdf](http://www.carters.ca/pub/article/charity/2004/tsc0304.pdf).

While these legislative changes were initiated by the Department, they were created in consultation with Canada Revenue Agency (“CRA”). Although the Federal Budget that was announced by the Department on March 23, 2004 also brought sweeping changes to the Act that affect charities, the changes embodied in the February 2004 Amendments were not affected by the Budget. The changes brought about by the March 2004 Budget and how they impact charities have been summarized in Charity Law Bulletin No. 41, entitled “March 2004 Federal Budget Rewrites Tax Rules for Charities.”<sup>4</sup>

## B. CONSOLIDATION OF AMENDMENTS

### 1. New Definition of Gift for Income Tax Purposes

At common law, property must be transferred voluntarily, without any contractual obligation and with no advantage of a material nature returned to the donor. Subsections 248(30) to (33) of the Act, introduced by the December 2002 Amendments, create a new concept of “gift” for tax purposes to provide a tax benefit to a donor even when the donor (or a person not dealing at arm's length with the donor) receives an advantage, provided that the value of the property exceeds the amount of advantage received. These subsections have been further amended by both the December 2003 and February 2004 Amendments. The Explanatory Notes to the February 2004 Amendments indicate that these subsections are added to “clarify the circumstances under which taxpayers and donees may be eligible for tax benefits available under the Act in respect of impoverishment of a taxpayer in favour of a donee.”

The new subsection 248(30) of the Act introduced by the December 2002 Amendments 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 any advantage received in respect of the gift. This subsection is amended slightly under the December 2003 Amendments to clarify that it is also applicable to monetary contributions made to registered parties and candidates. Subsection 248(30) is included in the February 2004 Amendments without further changes and applies to gifts made after December 20, 2002.

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<sup>4</sup> *Charity Law Bulletin* No. 41 dated March 30, 2004 summarizing the 2004 Federal Budget’s affect on charities can be accessed at our website at [www.charitylawbulletin.ca/2004/chylb41.pdf](http://www.charitylawbulletin.ca/2004/chylb41.pdf).

The definition of “advantage” is set out in subsection 248(31) that was introduced by the December 2002 Amendments. This subsection was substantially amended by both the December 2003 and February 2004 Amendments. It has now become paragraph 248(31)(a) of the Act, which provides that the amount of advantage in respect of a gift 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 a person who does not deal at arm’s length” with the donor, or “another person or partnership who does not deal at arm’s length with and holds, directly or indirectly, an interest” in 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, (ii) in gratitude of, or (iii) in “any other way related to the gift.” (Changes to the original wording from the December 2003 Amendments have been underlined in the foregoing sentence.) Paragraph 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 6 p.m. on December 5, 2003.

This 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 implications. 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. Furthermore, the definition of advantage is silent regarding from whom the advantage may be provided. Presumably, it could also include advantages provided by third parties, even unbeknownst to the charity issuing the charitable donation receipt.

Subsection 248(33) of the Act, introduced by the December 2002 Amendments, provides that the cost of property to the donor is the fair market value of the property at the time when the gift is made. Paragraph 248(32)(a) provides that if the amount of the advantage does not exceed 80% of the fair market value of the property, then the existence 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 property, paragraph 248(32)(b) provides that it is up to the donor to establish to the satisfaction of the Minister that the transfer was made with the intention to make a gift. Subsection

248(32) as it was introduced by the December 2002 Amendments remains unchanged under the December 2003 Amendments, save and except the insertion of a clarification that the gifts in question are gifts made to “qualified donees.” Subsection 248(33), introduced by the December 2002 Amendments, also remains the same under the December 2003 Amendments, save and except the insertion of a clarification that this subsection also applies to monetary contributions made to registered parties and candidates. The wording of subsections 248(32) and (33) in the December 2003 Amendments is included in the February 2004 Amendments without further changes. These subsections apply to gifts made after December 20, 2002.

It is expected that this new concept of “gift” will encourage donations to charities. However, the precise impact of the application of this new concept of “gift” remains to be seen. While the new definition of gift is necessary in order to introduce the concept of split-receipting, it is problematic from the standpoint of ensuring that title has passed when a gift is made. Although a gift with an advantage back to the donor will be deemed to be a gift for income tax purposes, it will not be a gift at common law, which may lead to a challenge by donors or disgruntled family members at a later time. One possible solution would be to structure the gift as a contract with consideration flowing back to the donor. While this would ensure that title would pass when the gift is made, it would open up the question of whether there is the necessary rebuttable donative intent in order to presume a gift for tax purposes, as a contract, by its very nature, requires consideration back to the donor, thus negating the requisite intent to donate. An alternative solution would be to structure the gift as a charitable trust, since a charitable trust evidences a donative intent and can also accommodate a benefit back to the donor as one of the terms of trust, as is the case with a charitable remainder trust.

## 2. New Definitions of Charitable Organizations and Public Foundations

Under the December 2002 Amendments, the definitions of charitable organizations and public foundations in subsection 149.1(1) are amended by replacing the previous “contribution” test with a new “control” test. The rationale for amending the definitions is to permit such charities to receive large gifts from donors without concern that they may be deemed to be private foundations. The

changes to subsection 149.1(1) introduced by the December 2002 Amendments are consolidated in the February 2004 Amendments.

The original provisions of the Act require that not more than 50% of the capital contributed or otherwise paid to a charitable organization or public foundation 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. This is usually referred to as the "contribution" test. As a result of inquiries from the public, the Department proposed to amend the definition of both charitable organizations and public foundations in order to "ensure that in certain circumstances large donations are not prohibited" by permitting a person, or a group of persons not dealing with each other at arm's length, to contribute more than 50% of the charity's capital as long as such a person or group does not control the charity in any way or represent more than 50% of the directors, trustees, officers and similar officials of the charity. In general, this new definition is retroactively applicable to January 1, 2000. The changes introduced by the December 2002 Amendments are included in the February 2004 Amendments with the addition of minor wording in subparagraph (d)(ii) of both definitions to clarify the meaning of the new definition.

Registered charities that wish to apply under subsection 149.1(6.3) to change their designation as a result of the amendments described above will be required to apply within 90 days of when the February 2004 Amendments receive Royal Assent. These registered charities will then 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 specifies.

As a result of the introduction of a "control" test, the convoluted rules under the Act in relation to "control" will become applicable, specifically due to the inclusion of the phrase "controlled directly or indirectly in any manner whatever" contained in the new definitions. However, the application of the rules concerning "control" in the charitable context is unclear, since these rules are premised upon application to commercial arrangements in a business context rather than for charitable corporations. As such, charity law practitioners will need to carefully review these rules when establishing charitable organizations and public foundations involving a major donor who contributed more than 50% of the capital for a charity, especially in the case of establishing a multiple corporate structure, in order to

ensure that the charity in question will not inadvertently be caught by these rules that might otherwise lead to the unintended result of a charity being deemed a private foundation. As well, the current relationship of multiple corporate structures should also be reviewed in order to assess whether this new control test may have an undesirable effect.

### 3. Tax Shelter Donation Deeming Provision

The definition of tax shelter was amended by the Federal Budget released on February 28, 2003, to include gifting arrangements, tax credits, refunds and deductions, since previously only deductions from income or taxable income were accounted for when determining whether or not an arrangement was a tax shelter. The February 2003 Budget was passed into law on June 19, 2003 via Bill C-28, *An Act to implement certain provisions of the budget tabled in Parliament on February 18, 2003*.

As a result of concerns raised by the public and CRA involving promoters selling “buy-low, donate-high” donation schemes that often provide the donor with extraordinary tax-benefits, the December 2003 Amendments propose changes to shut down these schemes. 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, then the fair market value of the property donated shall be “deemed” to be the lesser of (i) the “fair market value of the property otherwise determined” and (ii) the cost 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. Subsection 248(36) states that the Deeming Provision does not apply to inventory, real property situated in Canada, certified cultural property, publicly traded shares or ecological gifts. Paragraph 248(35)(a) applies to gifts made on or after 6 p.m. on December 5, 2003 and is brought forward and included, unchanged, in the February 2004 Amendments.

Given the numerous warnings by CRA leading up to the proposed amendments to the Act, charities that did become involved in tax shelter donation schemes may have cause for concern as CRA may decide to initiate assessments of a charities that were involved in one of these schemes. In the future, charities and their boards will want to be extremely 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.

#### 4. Other Applications of the Deeming Provision

The Deeming Provision introduced by the December 2003 Amendments in relation to donation of property acquired through gifting arrangements, as defined above, also applies to donation of property under two other situations. First, pursuant to subparagraph 248(35)(b)(i), the Deeming Provision applies if a donor acquires property and donates it within three years from the date of acquisition. Second, pursuant to subparagraph 248(35)(b)(ii), 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 an expectation to make a gift at the time when the property was acquired, the Deeming Provision would apply. Practically, the burden is on the donor to prove there was no expectation to make a gift when the property was acquired. Paragraph 248(35)(b) does not apply to gifts exempted under subsection 248(36) or to situations where a gift is made as a consequence of a donor’s death. Paragraph 248(35)(b) applies to gifts made on or after 6 p.m. on December 5, 2003, and is included, unchanged, in the February 2004 Amendments.

The application of the proposed Deeming Provision to gifts made outside of tax shelter donation arrangements will have serious practical implications concerning how charities will need to operate in terms of acceptance of gifts and the issuance of charitable donation receipts, including possibly inquiring of donors when donated property was acquired and obtaining written confirmation of the same. From a practical standpoint, this will be a difficult task for many charities to undertake. Although practically, the burden will be on the donors to prove the lack of expectation to make a gift when the property was acquired, it raises a concern whether charities will be compelled to inquire of donors to determine whether they had an expectation to make a gift when the property was acquired. It is also conceivable that the Deeming Provision could include unintended situations, such as the donation of privately held shares owned for more than three years where the donor had exchanged the original shares for shares of another class within three years of donating them to a charity.

5. Restricting the Use of Tax Shelter Donations involving Limited Recourse Debt

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”). The December 2003 Amendments proposed to curtail gifting arrangements involving limited-recourse debts incurred by donors by introducing a series of amendments to the Act, including the insertion of new subsections 143.2(6.1), 248(31)(b) and 248(34), as well as amendment of the wording in subsection 143.2(13) before paragraph (a). The cumulative effect of these provisions is to reduce the amount of the gift by the amount of the loan 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. These amendments only apply to donations made after February 18, 2003 and have been included, unchanged, in the February 2004 Amendments, save and except minor wording changes in subsection 143.2(6.1) and 248(34).

6. Anti Avoidance Rule

The December 2003 Amendments also introduced an anti-avoidance rule in the new subsection 248(37) to the Act. The Explanatory Notes to the February 2004 Amendments indicate that this subsection is intended to prevent a donor from avoiding the application of subsection 248(35) by disposing and reacquiring a property before donating it to a qualified donee. It 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 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 is included, unchanged, in the February 2004 Amendments and applies to gifts made on or after 6 p.m. on December 5, 2003.

7. Revocation of Charitable Registrations

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, subsections 149.1(2), (3), and (4) will be amended to provide that gifts made by a charity to a non-qualified donee would become



cause for revocation of the charitable status of the charity. These changes are included in the February 2004 Amendments without change and would apply to gifts made by charities after December 20, 2002.

As a result of the possible loss of charitable status in making a disbursement to a non-qualified donee, charities will need to be more cautious than ever when making disbursements and ensure that all disbursements are either made in the course of carrying out their charitable activities or to qualified donees and that no disbursements are made to non-qualified donees unless there is an agency, joint venture or partnership agreement in place in accordance with the requirement of CRA.

### C. NEW AMENDMENTS

In addition to consolidating and amending legislative changes introduced by the December 2002 and December 2003 Amendments, the February 2004 Amendments also introduced two new changes to the Act.

#### 1. Substantive Gift

The February 2004 Amendments proposed the insertion of a new subsection 248(38) that applies to gifts of capital property and eligible capital property made on or after February 27, 2004, in order to prevent a donor from avoiding the application of the Deeming Provision set out in subsection 248(35) by disposing the property to a qualified donee and then donating the proceeds of disposition 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, rather than donating the property directly to the qualified donee. The property disposed of by the donor is referred to as a "substantive gift" in this subsection. Under these situations, the Deeming Provision set out in subsection 248(35) would apply and the fair market value of the substantive gift and proceeds of sale would be "deemed" under subsection 248(38) 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 the disposition of the property to the qualified donee. This subsection does not apply to property exempted under subsection 248(36) referred to above.

2. New Qualified Donees

The February 2004 Amendments also propose to amend sections 110.1 and 118.1 of the Act by expanding the list of “qualified donees” as defined in section 149.1(1) to include municipal or public bodies performing a function of government in Canada. The Tax Court of Canada, in the case *Otineka Development Corporation Limited and 72902 Manitoba Limited v. The Queen*<sup>5</sup> held that an entity could be considered a municipality for the purpose of paragraph 149(1)(d.5) on the basis of the functions it exercised. However, the Quebec Court of Appeal in *Tawich Development Corporation v. Deputy Minister of Revenue of Quebec*<sup>6</sup> held that an entity could not attain the status of a municipality by exercising municipal functions but only by statute, letters patent or order. In response to the Quebec Court of Appeal decision in *Tawich*, the February 2004 Amendments expand the definition of qualified donee in order to ensure that municipal or public bodies performing a function of the government in Canada are included.