
MARCH 2004 FEDERAL BUDGET REWRITES TAX RULES FOR CHARITIES

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A. INTRODUCTION

The Federal Budget announced on March 23, 2004, (the “2004 Budget”) represents a major initiative by the Federal Government in rewriting the tax rules concerning the taxation and administration of charities. The 2004 Budget reflects to a large extent the proposals of the Voluntary Sector Initiative’s Joint Regulatory Table contained in its report of March 2003 “Strengthening Canada’s Charitable Sector: Regulatory Reform”, particularly as it relates to intermediate taxes and sanctions. The 2004 Budget also rectifies a number of technical problems regarding disbursement quotas involving charities, most of which were identified in submissions by the Charities and Not-for-Profit Law Section of the Canadian Bar Association over the last three years. The proposals that are set out in the 2004 Budget should be read in addition to the February 27, 2004 Revised Draft Technical Amendments, which were commented on in *Charity Law Bulletin* No. 40,¹ as well as in a paper by the authors entitled “Recent Changes to the *Income Tax Act* and Policies Relating to Charities and Charitable Gifts (current to March 1, 2004).”²

¹ *Charity Law Bulletin* No. 40 dated March 29, 2004 is available on our website at www.charitylawbulletin.ca/2004/chylb40.pdf.

² 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 Estate and Trust Practitioners on March 4, 2004 is available on our website at <http://www.carters.ca/pub/article/charity/2004/tsc0304.pdf>

The specific wording of the proposed changes contained in Annex 9 of the 2004 Budget affecting charities is set out in Schedule A to this *Charity Law Bulletin*. In addition, the full text of the 2004 Budget can also be found at www.fin.gc.ca/budget04/pdf/bp2004e.pdf.

What follows is a brief description of some of the key proposals set out in the 2004 Budget affecting charities, as well as selective comments on the proposals. However, until the enabling legislation is drafted, the full extent and impact of the proposals in the 2004 Budget will remain somewhat speculative. The old adage of “the devil is in the details” would have appropriate application to the enabling legislation to come, which may not be available until the fall of this year. Further commentary will be provided in future *Charity Law Bulletins* as the position of the Federal Government becomes clearer concerning the exact wording to be included in the enabling legislation,. In the meantime, the following are our preliminary comments to date.

B. NO TRADING CHARITABLE DONATIONS

Individuals who make charitable donations may carry forward their unused credit balance for up to five years. Similarly, corporations may also carry forward unused charitable donation deductions for up to five years. However, the *Income Tax Act* (the “Act”) does not permit individuals or corporations to sell or transfer these unused claims to other taxpayers.

To ensure that an individual who could not otherwise use surplus charitable donation tax credits also cannot do so indirectly by means of a transfer of property to a corporation, the 2004 Budget proposes that the Act be amended to provide that charitable donation deductions of a corporation that were unused at the time control of the corporation was acquired will be claimable only for taxation years that end before that acquisition of control. This will ensure that unused charitable donation deductions cannot be traded by having unused charitable donation deductions of a corporation treated in a manner that is similar to the treatment accorded to capital losses. The Act currently includes provisions that restrict the deductibility of accumulated losses and other tax pools after control of a corporation is acquired. In this regard, a corporation that realizes capital losses before an acquisition of control of the corporation cannot be carried forward for deduction after the acquisition of control.

The 2004 Budget also proposes that no charitable donation deductions will be allowed in respect to a gift of a property by a corporation after the time control of the corporation has been acquired, if the property was acquired by the corporation before that time under an arrangement under which it was expected that control of the corporation would be so acquired and a gift would be so made.

These amendments will apply in respect to gifts made after March 22, 2004.

C. INTERMEDIATE SANCTIONS AND RELATED MATTERS

1. Intermediate Taxes and Penalties

Prior to the 2004 Budget, the only sanction that Canada Revenue Agency (“CRA”) could impose on a registered charity that did not comply with the requirements of the Act was to revoke its status as a registered charity. The consequence of revocation is that the registered charity must either transfer its assets to one or more qualified donees within one year of the date of revocation or pay a 100% tax on the remaining property of the registered charity. This tax is referred to as a revocation tax under Part V of the Act.

To overcome the harshness of imposing revocation for minor infractions, the 2004 Budget proposes a more responsive approach to the regulation of charities under the Act by introducing sanctions that are more appropriate than revocation for relatively minor breaches of the Act. The sanctions will be progressive, generally increasing in severity for repeat infractions. These measures will apply in respect of taxation years that begin after March 22, 2004. The proposed sanctions and taxes can be summarized as follows:

a) Taxation of Gross Revenue

Gross revenue generated by a registered charity from prohibited activities will be taxed at rates between 5% for first infractions up to 100% for repeat infractions for the following:

- Private foundations carrying on a business activity;
 - Charitable organizations and public foundations carrying on an unrelated business activity;
- and

- Foundations that acquire control of a corporation through means other than those allowed under the Act.

b) Suspension of Tax Receipting Privileges

Registered charity tax receipting privileges will be suspended for using donated funds other than for charitable purposes and for failure to comply with certain verification and enforcement sections of the Act, such as keeping books and records. Where a registered charity provides undue benefits to “any person”, including “trustees”, not only will the tax receipting privileges be suspended for a repeat infraction, but there will also be the imposition of a 105% tax for a first infraction and 110% tax for a second infraction on the amount of the undue benefit. This means that directors of charities will become obligated to ensure that the salaries paid to its employees, particularly its chief operating officers (including, in the event of churches, its pastors and ministers) is reasonable in the circumstances. It will therefore be prudent to conduct a comparison in salaries for all staff as well as contract workers. However, it will be necessary to carefully review the specific wording of the enabling legislation before making a determination in this regard.

c) Monetary Penalties

The 2004 Budget imposes monetary penalties of \$500 for failure to file annual information returns, together with the publication of the names of late or non-filers.

d) Tax on Gifts and Transfers to Other Registered Charities

The 2004 Budget imposes a 125% tax on the stated eligible amount of a gift if there is in fact no gift or if the receipt contains false information. In addition, if such receipt exceeds \$20,000, then tax receipting privileges of the charity will be suspended. Where a registered charity issues receipts with incomplete information, there will be a 5% penalty on the eligible amount stated on the receipt for a first infraction, and a 10% penalty on repeat infractions. In addition, where a charity is involved in delaying the expenditure of money on charitable activities by transferring the funds to another registered charity, both charities involved will be jointly and separately liable for the amounts so transferred together with a 10% tax on such amounts. In situations where a gift

that is restricted under subsections 149.1(2), (3), or (4) of the Act, there will be a 105% tax on the amount of the gift for a first infraction, and a 110% tax on repeat infractions.

The following chart is included in the 2004 Budget to provide specifics of the infraction in question, together with taxes and penalties that apply for both first infractions and repeat infractions:

Infraction	Tax or Penalty (Unless registration of the charity is revoked)	
	First infraction	Repeat infraction (Repeated acts or omissions will increase the probability of revocation)
Late filing of annual information return	\$500 penalty	\$500 penalty
Issuing of receipts with incomplete information	5% penalty on the eligible amount stated on the receipt	10% penalty on the eligible amount stated on the receipt
Failure to comply with certain verification and enforcement sections of the Income Tax Act (230 to 2315), eg keeping proper books and records	Suspension of tax-receiving privileges	Suspension of tax-receiving privileges
Charitable organization or public foundation carrying on an unrelated business	5% tax on gross unrelated business revenue earned in a taxation year	100% tax on gross unrelated business revenue earned in a taxation year and suspension of tax-receiving privileges
Private foundation carrying on any business	5% tax on gross business revenue earned in a taxation year	100% tax on gross business revenue earned in a taxation year, and suspension of tax-receiving privileges
Foundation acquires control of a corporation	5% tax on dividends paid to the charity by the corporation	100% tax on dividends paid to the charity by the corporation
Undue personal benefit provided by a charity to any person. For example, a transfer to a person who does not deal at arm's length with the charity or who is the beneficiary of a transfer because of a special relationship with a donor or a charity	105% tax on the amount of undue benefit	110% tax on the amount of undue benefit and suspension of tax-receiving privileges
A gift that is restricted under subsections 149.1(2), (3) or (4) of the Act	105% tax on the amount of the gift	110% tax on the amount of the gift
Issuing receipts in a taxation year for eligible amounts that in total do not exceed \$20,000 if there is no gift or if the receipt contains false information	125% tax on the eligible amount stated on the receipt	125% tax on the eligible amount stated on the receipt

Infraction	Tax or Penalty (Unless registration of the charity is revoked)	
	First infraction	Repeat infraction (Repeated acts or omissions will increase the probability of revocation)
Issuing receipts in a taxation year for eligible amounts that in total exceed \$20,000, if there is no gift or if the receipt or if the receipt contains false information	Suspension of tax-receipting privileges and 125% tax on the eligible amount stated on the receipt	Suspension of tax-receipting privileges and 125% tax on the eligible amount stated on the receipt
Delaying expenditure of amounts on charitable activities through the transfer of funds to another registered charity	The charities involved are jointly and severally, or solidarily, liable for the amounts so transferred plus a 10% tax on those amounts	The charities involved are jointly and severally, or solidarily, liable for the amounts so transferred plus a 10% tax on those amounts
<p>Notes:</p> <p>These intermediate sanctions will not prevent application of the current provisions, which allow the Minister of National Revenue to revoke the registration of a charity in respect of any of the above infractions. For example, failure to file an information return may result in revocation of registered status upon a first infraction.</p> <p>This chart does not include infractions for which no tax or penalty would be assessed, yet which would lead to revocation, e.g. ceasing to conduct charitable activities.</p> <p>Taxes and penalties will be assessed in aggregate for a taxation year.</p> <p>A repeat infraction is an action in a taxation year that gives rise to a tax or penalty in respect of which an assessment was previously raised for a preceding taxation year.</p> <p>Rules of general application may also apply in addition to the sanctions referred to above, e.g. the failure to keep proper books and records is an offence punishable by a fine or imprisonment.</p>		

2. Transfer of Amounts in Respect of Taxes and Penalties

Where a charity is required to pay taxes or penalties which total more than \$1,000 in a particular taxation year, the charity will be permitted to transfer such amount to eligible donees that satisfy all of the following conditions:

- ◆ The donee is not subject to any tax, penalty or suspension, etc. under the Act;
- ◆ The donee is not subject to a certificate pursuant to the Charities Registration (Security Information) Act (i.e. a part of the Anti-terrorism Act); and
- ◆ The donee is a registered charity with more than 50% of the members of its board of directors dealing at arm’s length with each member of the board of directors of the charity that is subject to the tax penalty.

3. Revocation and Annulment

The Minister retains the right to revoke the registered status of a charity in the event of severe breaches of the Act, including where the organization is being operated for purposes that are not charitable or where an organization obtained its registration status on the basis of false or deliberately misleading information. The 2004 Budget also requires that the assets of a registered charity whose charitable status has been revoked can only be transferred to “eligible donees” referred to above, rather than to the

full list of qualified donees, such as municipalities or foreign universities. In addition, if the Minister believes that assets are being diverted or directed for private benefit, then CRA can obtain authorization from a judge to commence collection proceedings against a charity immediately after revocation, instead of waiting for the normal expiration of one year from the date of revocation.

The 2004 Budget will provide explicit authority to the Minister to annul an organization's registration in circumstances where the organization was registered in error. The benefit of an annulment is that the normal 100% Part V revocation tax will not apply. As well, official receipts issued prior to annulment will be honoured.

The new measures in relation to annulment, as well as revocation, will apply to notices issued by the Minister after the later of December 31, 2004 and 30 days after Royal Assent to any measures giving effect to this proposal.

D. APPEALS REGIME

The 2004 Budget attempts to make the appeal process more accessible and affordable for registered charities and unsuccessful applicants for charitable status than it has been in the past.

1. Internal Reconsideration Process

The 2004 Budget proposes to extend the application of CRA's existing internal objection review process to notices of a decision regarding denial of applications for charitable status, revocation or annulments of a charity's registration, designation of a charity as a private or public foundation or charitable organization, or the imposition of any taxes or penalties against a registered charity.

An organization that wishes to avail itself of the internal reconsideration process will be required to file a notice of objection within 90 days from the issuance by CRA of the notice which is being objected to. The results of the review will be communicated in writing and no appeal can be made to a court unless the objection process has been availed of.

2. External Appeals Process

Appeals from decisions concerning refusal to grant registered charitable status or revocation of registered charitable status will need to continue to be made to the Federal Court of Appeal. This is unfortunate, as an appeal in this regard is a very costly process that few charities are in a financial position to pursue. Appeals of decisions to annul the registration status of a charity will also be directed to the Federal Court of Appeal. Appeals of taxes and penalties referred to above will be directed to the Tax Court of Canada.

The new objection and appeal process will not apply to an applicant or registered charity that is subject to a certificate under the *Charities Registration (Security Information) Act*.

The new internal reconsideration process, as well as the external appeals process will apply to notices of decisions that are issued by the Minister after the later of December 31, 2004 and 30 days after Royal Assent to any measure giving effect to this proposal.

E. TRANSPARENCY AND ACCESSIBILITY OF INFORMATION

1. Information Pertaining to Registered Charities

Prior to the 2004 Budget, the public could only obtain copies of annual information returns, governing documents with the names of directors, registration letters, and notices of revocation in relation to registered charities. The 2004 Budget proposes to authorize the Minister to release to the public the following additional information where such information has been submitted to the Minister after 2004:

- ◆ Financial statements that are filed with the annual information return;
- ◆ Letters to a charity relating to grounds for annulment;
- ◆ The decision of CRA regarding a notice of objection filed by a registered charity;
- ◆ Information to support an application by a registered charity for special status or an exemption under the Act (e.g. request for permission to accumulate assets); and
- ◆ The identification of the registered charity which is subject to a sanction, the type of sanction imposed, as well as the letters sent to the registered charity relating to the grounds of the sanction.

2. Information Concerning Organizations that are Denied Registration

Since CRA cannot identify to the public an organization that is denied charitable status, the 2004 Budget proposes to permit CRA to make available the following information in a manner that will protect the identity of the applicant but will provide the charitable sector with an understanding of how CRA determines when an organization will be eligible to become a registered charity:

- ◆ The governing documents of the organization, including its statement of charitable purposes;
- ◆ Information disclosed by the organization in the course of the application;
- ◆ A copy of the notice of denial in respect to the organization; and
- ◆ A copy of the decision, if any, of CRA's Appeals Branch regarding any notice of objection if filed by the organization.

3. Additional Information on Official Tax Receipts

For official tax receipts issued after 2004, the 2004 Budget proposes to require that, in addition to all of the prescribed information currently required by CRA, the name and website address of CRA also be included.

4. Increased Website Information

The 2004 Budget proposes that CRA will post on its website the reason for its registration decisions, as well as its policies, procedures, and research databases it uses for its decision making. The research databases will likely be considerable, as there are apparently more than 700 cases that CRA utilizes as precedents for its decision making.

5. Charities Advisory Committee

The 2004 Budget also indicates that registered charities will now have more input into shaping the administration of tax rules affecting charities through a newly created Charities Advisory Committee. This committee is to be comprised of sector representatives who are mandated to advise the Minister on administrative issues involving registered charities.

F. DISBURSEMENT QUOTA RULES

1. Reduction of Disbursement Quota Rate

The 2004 Budget proposes to reduce the 4.5% disbursement quota that currently applies to public and private foundations to a more manageable rate of 3.5%. The rate is to be reviewed periodically to ensure that it continues to be representative of long-term rates of return. Apparently, the formula that was used by the Department of Finance for the 2004 Budget was based on the current real rate of return minus 20% attributable to administrative costs. In the event that a registered charity is not able to meet the reduced 3.5% disbursement quota, it can still apply for dispensation to reduce the disbursement quota in accordance with subsection 149.1(5) of the Act. The reduction of the 4.5% disbursement quota to 3.5% applies to taxation years that begin after March 22, 2004.

2. Extension of 3.5% Disbursement Quota to Charitable Organizations

In the past, only public and private foundations were subject to a disbursement quota upon its capital assets not used in charitable activities. However, the 2004 Budget proposes that the reduced 3.5% disbursement quota on capital assets will also apply to charitable organizations. For charitable organizations registered before March 23, 2004, the disbursement quota will apply to their taxation years that begin after 2008. For charitable organizations registered after March 22, 2004, however, the disbursement quota will apply to their taxation years that begin after March 22, 2004.

With the removal of this key distinction between charitable organizations and foundations, there will be little functional difference between the two, other than the 50% income disbursement rules. It would therefore not be surprising if the Federal Government, as a matter of policy, eventually eliminates the distinction between charitable organizations and foundations altogether so that there would be only two categories of charities, i.e. charities and private foundations. It will be interesting to see what may transpire in this regard over the next few years.

3. Realizing Capital Gains from Endowments

The 2004 Budget proposes to rename 10 year gifts as endowments. Although this is probably a simpler term to work with, it should be remembered that the term “endowment”, used in the context of the Act,

means a gift that the donor requires the charity to hold for a least 10 years, which may constitute a perpetual endowment depending on the terms of the gift but does not necessarily mean that all “endowments” will in fact be perpetual endowments.

Although not specifically stated in the 2004 Budget document, it appears that the intent of the 2004 Budget is to allow the expenditure of capital gains accruing on the original endowment, provided that the terms of the endowment do not preclude the expenditure of capital gains. This will be an important and welcomed relief for many charities that hold endowment funds.

In addition, if there is an expenditure of capital gains of an endowment, the previous anomaly that 80% of the disbursement of the capital gain had to be added to the disbursement quota of a charity will now be alleviated by reducing the 80% disbursement quota by the lesser of 80% of the capital gain realized on the disposition and 3.5% of the value of all property not used directly in charitable activities or administration. These proposals will apply to taxation years that begin after March 22, 2004.

4. Transfer of Endowments

Previously, if a charity was to transfer an endowment to another charity, a drafting error in the Act meant that the transferee charity would have to expend 80% of the endowment in the year following the transfer of the gift. This anomaly required that both the transferor and the transferee charity had to obtain relief by applying for dispensation from the application of the disbursement quota under subsection 149.1(5) of the Act. The 2004 Budget proposes that an endowment received by a registered charity from another registered charity would result in the same treatment as if the endowment had been received directly from the original donor. This proposal also applies to taxation years after March 22, 2004.

5. Gifts Transferred to Charitable Organizations

Previously, only transfers from registered charities to public and private foundations were subject to the 80% disbursement quota, which meant that transfers from registered charities to charitable organizations were exempt from the 80% disbursement quota. The 2004 Budget proposes that all

transfers from one registered charity to another, including transfers to a charitable organization, will be subject to the 80% disbursement requirement. The only exception will be for transfers involving specified gifts and transfers of capital endowments. These changes will apply to transfers received by charitable organizations in taxation years that begin after March 22, 2004.

6. Gifts Made by Way of Direct Designation

Where an individual has designated in his/her will a charity as a direct beneficiary of the individual's RRSP, RRIF or life insurance policy, the 2004 Budget proposes to treat such gifts as endowments for the purposes of the disbursement quota rules. This will mean that direct designation of RRSP, RRIF and life insurance proceeds will be subject only to the 3.5% disbursement quota while they are held as capital by the recipient charity and then subject to the 80% disbursement quota requirement in the year in which they are disbursed. This proposal will apply to taxation years beginning after March 22, 2004.

7. Endowments Received and Spent in the Same Year

At present, endowments are subject to an 80% disbursement quota to the extent that the registered charity liquidates and spends the capital in the year following the year in which the gift is received. The current rules, however, do not address the situation where the charity receives an endowment and disburses it in the same year. The 2004 Budget now proposes to eliminate this loop-hole by applying the 80% disbursement quota to gifts of capital that are liquidated in the same year that they are received. This proposal will also apply to taxation years that begin after March 22, 2004.

G. NEW NOT-FOR-PROFIT CORPORATIONS ACT

The 2004 Budget also includes a commitment by the Federal Government to introduce a new *Not-For-Profit Corporations Act* that will reduce the regulatory burden on the not-for-profit sector, improve financial accountability, clarify the roles and responsibilities of directors and officers, and enhance and protect the rights of members. The 2004 Budget indicates that the new legislation will be flexible enough to meet the needs of both small and large organizations while providing the accountability and transparency necessary to maintain the public trust and confidence in the voluntary sector.

At present, Part II of the *Canada Corporations Act* provides the framework for the incorporation and governance of federal non-share capital corporations. As a result of concerns that the *Canada Corporations Act* is out-dated, Industry Canada put forward a “Reform of the Canada Corporations Act: Draft Framework for a New Not-For-Profit Corporations Act” in 2002.

Although a new *Not-For-Profit Corporations Act* does not have anything directly to do with the *Income Tax Act*, the fact that the legislation is mentioned in the 2004 Budget evidences a commitment by the Federal Government to move forward in putting this new legislation in place.

H. CHARITIES BANK

Also of note, the 2004 Budget includes an intention by the Federal Government to explore the possibility of establishing a bank targeted at the unique needs and challenges of the charitable sector. The Federal Government indicates that it will work with the proponents of this idea as they pursue the federal regulatory and taxation issues associated with the establishment of a charity bank.

Proponents of this concept hope that the bank will offer a wide range of financial services, including holding deposits from charities or even from the general public, as well as providing investment banking and money management services. This idea is based on the Charity Bank that opened in England in 2002.

It is still too early to speculate on the outcome of this new concept. However, it may be anticipated that the operation of a charity bank in Canada will impact some community foundations that offer a service of pooling investments on behalf of local charities.

I. CONCLUSION

The collection of proposals in the 2004 Budget represents the most significant rewrite of the tax rules affecting charities under the Act in the last twenty years and will affect charities for many years to come. However, until the enabling legislation for the 2004 Budget is drafted, we will not know the full extent and implications of the Budget proposals. As we have seen in the Revised Draft Technical Amendments released on February 27, 2004, there are often unintended consequences flowing from the wording of technical draft

tax legislation. Hopefully, over the next several months, the Department of Finance, as well as CRA, will be amenable to suggestions regarding the specific wording of the enabling legislation for the Budget. In the meantime, the Department of Finance and CRA are to be commended for the positive initiatives that are set out in the 2004 Budget proposals. Clearly the proposals are indicative of a new attitude of listening, co-operation and partnering between the government and the voluntary sector.



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