CARTERS.ca

CHARITY LAW BULLETIN NO. 86

CARTERS PROFESSIONAL CORPORATION

FEBRUARY 7, 2006

Barristers, Solicitors & Trade-mark Agents / Avocats et agents de marques de commerce

Affiliated with **Fasken Martineau DuMoulin LLP** / Affilié avec Fasken Martineau DuMoulin S.E.N.C.R.L., s.r.l.

Editor: Terrance S. Carter

FOUNDATIONS INCURRING DEBTS TO PURCHASE INVESTMENTS

By Theresa L.M. Man, B.Sc., M. Mus., LL.B.

A. INTRODUCTION

On October 21, 2005, Canada Revenue Agency ("CRA") reversed its strict position with respect to public and private foundations incurring debts for the purpose of acquiring investment, enabling both to now do so. Previously, CRA had always been of the view that the phrase "debts incurred in connection with the purchase and sale of investments" in paragraphs 149.1(3)(d) and 149.1(4)(d) of the *Income Tax Act* (Canada)[1] (the "Act") would only permit a miscellaneous type of debt, such as brokerage fees or other incidental amounts that could relate either to the purchase or the sale.

B. RESTRICTIONS UNDER THE ACT ON FOUNDATION TO INCUR DEBTS

Since June 1, 1950, charitable foundations[2] have been prohibited from incurring debts other than debts for current operating expenses, the purchase and sale of investments, or the administration of the charitable activities. Paragraphs 149.1(3)(d) and 149.1(4)(d) of the Act provide that the incurring of such debts by charitable foundations could be cause for revocation of their charitable status. This restriction does not apply to charitable organizations.

By way of background, for the first time in 1950, charities were divided into "charitable organizations," "charitable trusts," and "charitable corporations."[3] Some of the rules that applied to these three types of charities became the predecessor of some of the current requirements under the Act that apply to registered charities, including their organizational form, "prohibitions against carrying on a business and against

financing programs with debts," and "a rudimentary disbursement regime."[4] In particular, "charitable corporations" could not incur any debts since June 1, 1950, other than obligations for salaries, rents and other current operating expenses.[5] When charities were re-categorized in 1977 according to their functions, into active charities (i.e. charitable organizations) and passive charities (i.e. charitable foundations that included public foundations and private foundations),[6] the former restriction on charitable corporations to incur debts was retained and charitable foundations were prohibited from incurring debts. The purpose of the restrictions on foundations to incur debts is "to limit the permissible risks undertaken by foundations."[7]

C. CRA'S FORMER POLICY

Historically, CRA has strictly interpreted the Act's use of the phrase "debts incurred in connection with the purchase and sale of investment," being of the view that the type of debts contemplated by this phrase would be a miscellaneous type of debts such as brokerage fees or other incidental amounts that could relate either to the purchase or the sale. CRA maintained that foundations are prohibited from incurring debts for the purpose of permitting a foundation to purchase investments, or for the purpose of using the loan proceeds to discharge debts which were, when incurred, permitted under the Act. Details of CRA's view were set out in technical interpretations dated April 4, 1997 (#9700205) and October 4, 1995 (#9428885).[8]

In coming to this conclusion, CRA relied on the "ordinary rules of statutory interpretation" found in the 1994 decision of the Supreme Court of Canada in *Corporation Notre-Dame de Bon-Secours v. Commuanuté urbaine de Québec and City of Québec*.[9] The court held that "the words of an Act are to be read in their entire context in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act and the intention of parliament," and that the "first consideration should therefore be to determine the purpose of the legislation, whether as a whole or as expressed in a particular provision."[10]

CRA applied this interpretative approach and indicated that the phrase "purchase and sale" and the type of debt referred to in the words "in connection with" could only permit "a miscellaneous type of debt such as brokerage fees or other incidental amounts that could relate either to the purchase or the sale."[11] Consequently, this would "certainly exclude a debt relating to the purchase price as there is no similar loan or debt which would arise on a sale."[12] CRA then indicated that the words "debts for current operating expenses" and "debts incurred in the course of administering charitable activities" would be "an indication of short term debt of smaller amounts and not long term debt or loans for purposes of purchasing investments in

that such acquisitions have a connotation of long term larger amounts." Therefore, CRA was of the view that "if it was intended that the excepted debts were to include unlimited debt for the purchase of long term investments, there would be few, if any, debts prohibited by paragraph 149.1(3)(d) and 149.1(4)(d) of the Act."[13]

D. CRA'S NEW POLICY

On October 21, 2005, CRA issued a new technical interpretation,[14] stating that CRA had revised its position such that debts incurred by charitable foundations for the purpose of acquiring investments are acceptable debts. CRA explained that the reason for the change in their policy was because "jurisprudence has confirmed that the phrase 'in connection with' has a very broad meaning." In this regard, CRA made reference to the 1983 Supreme Court of Canada decision in *Nowegijick v. The Queen*.[15] The court in the *Nowegijick* case, in deciding whether the taxpayer in question was exempt from tax under the *Indian Act*, held as follows:

> The words 'in respect of' are, in my opinion, words of the widest possible scope. They import such meanings as 'in relation to', 'with reference to' or 'in connection with.' The phrase 'in respect of' is probably the widest of any expression intended to convey some connection between two related subject matters.

Interestingly, the court in that case decided on the meaning of the phrase "in respect of," not the meaning of the phrase "in connection with," which is contained in paragraphs 149.1(3)(d) and 149.1(4)(d) of the Act. It is not clear from the 2005 technical interpretation what other "jurisprudence" it is referring to. In addition, the *Nowegijick* decision, released in 1983, was already in existence when CRA issued its earlier technical interpretation in the 1990s, and it is not clear why CRA did not rely on the *Nowegijick* decision until now.

CRA indicated in the technical interpretation that it is now acceptable for a foundation's directors and members to give interest-free loans to the foundation to enable the foundation to "acquire investments, pay current operating expenses or expend on charitable activities." CRA explained that (1) the borrowed money would increase the investment capital and therefore would give rise to a disbursement quota requirement, (2) the lender would not be entitled to a charitable donation tax credit if the loan is repaid by the foundation, and (3) if the lender forgives all of part of the debt, then the lender would be entitled to a charitable donation tax credit for the part of the debt that is forgiven at the time when the debt is forgiven. However, CRA indicated that debt arrangements would continue to be reviewed by CRA, especially those involving non arm's length parties, in order to ensure that there are no other issues, such as personal benefit.

Regardless of the reason for the change in view, CRA's change in policy in this regard is a welcome change for foundations.

[1] R.S.C. 1985, c. 1 (5th Supp.), as amended (hereinafter referred to as the "Act").
[2] Charitable foundations include both public foundations and private foundations. See the definition for "charitable foundation," "public foundation" and "private foundation" in subsection 149.1(1) of the Act.
[3] *An Act to Amend the Income Tax Act*, S.C. 1950, c. 40.
[4] Ontario Law Reform Commission, *Report of the Law of Charities* (Toronto: Ontario Law Reform Commission, 1996) at 261 (hereinafter referred to as the "OLRC Report"). See also R. Appleby, "The Taxation of Charitable Institutions" (1973), 1(2) Philanthropist 17; J.G. Smith, "Taxation of Charitable Organizations Under the Income Tax Act" in Report of the Proceedings of the Twenty-fifth Tax Conference, 1973 (Toronto: Canadian Tax Foundation, 1973) 160; and E.A. Chater, "Administrative Aspects of the Taxation of Charitable Organizations Under the Income Tax Act" in Report of the Proceedings of the Twenty-fifth Tax Conference, 1973 (Toronto: Canadian Tax Foundation, 1973) 176.
[5] Paragraph 57(1)(eb) of the 1947-48 *Income Tax Act*.
[6] S.C. 1976-77, c. 4. The new changes to the *Income Tax Act* were enacted in 1976, effective January 1, 1977, in response to the Department of Finance's discussion paper, *The Tax Treatment of Charities* (Discussion Paper) (Ottawa: 23 June 1975), which was also referred to as the "Green Paper."
[7] OLRC Report, *supra* note 4 at 302; and see also David P. Stevens, "Update on Charity Taxation" in Report of Proceedings of Fifty-Third Tax Conference, 2001 (Toronto: Canadian Tax Foundation, 2002), 28:1-41 at 28:35.
[8] See also CRA technical interpretation OC90_222, 12 October 1990 and JN91_279, 4 June 1991.
[9] (1994) 3 S.C.R. 3.
[10] CRA technical interpretation 942885, 4 October 1995.
[11] *Ibid*.
[12] *Ibid*.
[13] *Ibid*.
[14] CRA technical interpretation 2005-015475117, 21 October 2005.
[15] 83 D.T.C. 5041 (S.C.C.).

CARTERS.ca

CARTERS PROFESSIONAL CORPORATION
Société professionnelle Carters
Barristers, Solicitors & Trade-mark Agents
Affiliated with Fasken Martineau DuMoulin LLP
Avocats et agents de marques de commerce
Affilié avec Fasken Martineau DuMoulin S.E.N.C.R.L., s.r.l.

Offices / Bureaux
Orangeville (519) 942-0001
Ottawa (613) 235-4774
Toll Free: 1-877-942-0001
www.carters.ca

By Appointment / Par rendez-vous
Toronto (416) 675-3766
London (519) 937-2333
Vancouver (877) 942-0001
www.charitylaw.ca