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BEWARE OF DONATION TAX SHELTER VALUATIONS

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A. INTRODUCTION

Registered charities and donors should be wary of the valuations provided by promoters of donation tax shelters following a recent Federal Court of Appeal decision in *Nash v. Canada* ("*Nash*")[1] overturning the Tax Court of Canada. The release of the Federal Court of Appeal's decision coincided with Canada Revenue Agency's ("CRA") *Taxpayer Alert* dated November 22, 2005,[2] reminding potential investors to exercise caution with respect to certain donation arrangements, including gifting trust arrangements, leveraged cash donations, and buy-low donate-high arrangements. This *Charity Law Bulletin* will review the recent case law concerning donation tax shelters and their implications for donors.

B. RECENT CASE LAW

The *Nash* decision was a consolidation of actions brought by Caedmon Nash, Barbara Quinn and Susan Tolley, who brought their cases before the Tax Court of Canada on behalf of 1,850 taxpayers involved in an art-flip donation program run by CVI Art Management (the "promoter"), which they learned about from their financial planners. The promoter operated a program through which it sold groups of limited edition prints to individuals, arranged for appraisals, and located charities and universities to accept gifts of the prints which could issue official tax receipts. In the case of Mr. Nash, in October 1999, he paid $8,667 for 85 signed and numbered prints. Two months later, in December 1999, he donated 84 of the prints to Ferris State University

[1] [2005] F.C.J. No. 1921
[2] Available at http://www.cra-arc.gc.ca/newsroom/alerts/2005/a051122-e.html.

in Michigan, a prescribed university under the *Income Tax Act* ("ITA"), receiving an official tax receipt for $29,400. If his claim for a donation tax credit had been allowed, Mr. Nash would have been entitled to a refundable tax credit of about $13,000 – a net gain of in excess of $4,000.[3]

The Tax Court of Canada decisions allowed the taxpayers' claims for the donation tax credit, relying heavily on the evidence of the taxpayers' appraiser that the fair market value of the prints donated in Mr. Nash's case was $29,932, in Ms. Quinn's case was $24,384, and in Ms. Tolley's case was $23,690. The valuations in each case were based on the assumption that determining the fair market value of a group of prints required an aggregation of the value of the individual prints in various retail markets.

In overturning the Tax Court decisions, the Federal Court of Appeal indicated that it was incorrect to assume that the fair market value of a group of items is necessarily the aggregate of the price that the individual items could be sold for, suggesting that the Tax Court and the appraiser ignored the evidence before them that the promoter sold the prints in groups and that the taxpayers donated the prints in groups. The Federal Court of Appeal questioned why the promoter would sell the prints to the taxpayers for less than 1/3 their subsequent value, concluding that there was no credible explanation for the discrepancy. The Court held that the most probative evidence of the fair market value of groups of prints in these circumstances was the actual purchase price paid by the taxpayers.

These decisions, along with the Federal Court of Appeal's decision upholding the Tax Court of Canada's decision in *Klotz v. Canada* ("*Klotz*"),[4] have been appealed to the Supreme Court of Canada largely on the basis that the courts have wrongly substituted their own judgment for the opinions of certified valuators. In *Klotz*, Associate Chief Justice Bowman of the Tax Court of Canada considered similar circumstances and found that the best evidence of fair market value was the very transaction through which the taxpayers purchased the art from the promoter. Mr. Klotz was one of 660 people who acquired limited edition prints that were immediately donated to prescribed colleges and universities under the ITA. The average cost of the prints was $300 yet the receipt that was issued was based on an average fair market value per print of about $1,000. Associate Chief Justice Bowman concluded that the valuations in that case were unrealistic and stated as follows:

[3] Barbara Quinn bought 48 prints for $8,648, which she donated to InKind Canada and received a receipt in the amount of $25,280. Susan Tolley purchased 100 prints for $8,025, 99 of which she donated to Fresno Pacific University and received a receipt in the amount of $28,325. Had their claims for the refundable donation tax credit been allowed, each would have been entitled to a refund of about $13,000.
[4] [2005] F.C.J. No. 754 (C.A.), aff'g [2004] T.C.J. No. 52 (T.C.C.).

> Why chase the will o' the wisp of an elusive and largely hypothetical [fair market value] through the trendy up scale art galleries of New York and ignore the best evidence that is right there before your very nose? The problem with the claim here, whereby property is acquired for $5 to $50, sold to the appellant for $300 and claimed to have a [fair market value] two days later of $1,000, is that it is devoid of common sense and out of touch with ordinary commercial reality.[5]

This passage was quoted with approval by the Federal Court of Appeal in *Nash*.

C. COMMENTARY

The Federal Court of Appeal decisions in *Nash* and *Klotz,* together with another recent decision of the Tax Court of Canada related to the donation of land to a charitable trust,[6] provide important guidance when reviewing valuation reports for the purposes of a tax claim. Fair market value generally means the highest price, expressed in dollars, that a property would bring in an open and unrestricted market between a willing buyer and a willing seller who are knowledgeable, informed, and prudent, and who are acting independently of each other. However, when reviewing a particular valuation report, the courts will base their decisions on the particular facts of a case, including the effective date of the valuation and the relevant market that needs to be considered. There are many areas of subjectivity in an appraisal report, including the selection of valuation methodology, the selection and input of various variables, the existence of any underlying assumptions, and the determination of the appropriate level of market. Registered charities and their advisors should be wary of appraisals that seem to be "value-driven" and self-serving, particularly with respect to the new structures involving software[7] and pharmaceutical products. The CRA and the courts thereafter will not hesitate to challenge such reports if they seem to be out of touch with commercial reality.

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[5] *Ibid*. at para. 46.

[6] *Corbett v. Canada*, [2005] T.C.J. No. 574 (T.C.C.). In this case the taxpayers donated a piece of property to a charitable trust. In assessing the taxpayers for 1996, the Minister used a value for both the charitable gift and the proceeds of disposition for capital gains purposes which the taxpayers did not accept. On their appeal to the Tax Court of Canada, the taxpayers alleged that the property had a value on December 26, 1996 of $2,843,622, but the Minister's figure was $394,000. At the hearing, the taxpayers' appraiser testified that the value was $850,000; the figure put forward by the Minister's appraiser was $369,000. The Court found inconsistencies in some of the statements made by the taxpayers' expert appraiser and, by adjusting some of that appraiser's calculations, concluded that the fair market value of the property was $363,985.

[7] See *CIT Financial Ltd. v. Canada*, 2004 D.T.C. 6573 (F.C.A.) for a case involving the valuation of software based on cashflows in a tax shelter context. See also *Malette v. Canada*, 2004 D.T.C. 6415 (F.C.A.) and *27 Cardigan Inc. v. Canada,* 2005 G.T.C. 1384 (F.C.A.) for further examples of the Courts reviewing valuation reports prepared for tax purposes.

D. CONCLUSION

Legislative proposals to curtail abusive tax shelter arrangements were again released by the Department of Finance on July 18, 2005. These amendments contain provisions which will deem the fair market value of gifted property to be the cost (usually purchase price paid) to the donor of the property if the property was acquired in certain situations, including if it was acquired by the donor as part of a "gifting arrangement" or within three years of the date of the donation. For more information on the legislative amendments, readers are directed to *Charity Law Bulletins* No. 30 and 76.[8]

These new provisions are intended to prevent the transactions considered in the cases discussed above by limiting the value of the donation tax credit to the price paid for the gifted property by the donor. However, there are a number of new tax shelter structures which claim to be unaffected by these new rules. The lesson to be learned from these recent cases from the Federal Court of Appeal is that tax advisors should always remember that just because a tax claim is supported by an independent appraisal does not guarantee smooth sailing when it comes to defending the transaction before the CRA and the courts.

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[8] Theresa L.M. Man "July 18, 2005 Draft Amendments To The *Income Tax Act* Affecting Charities Part I – Definition of Gift & Split-Receipting" *Charity Law Bulletin* No. 76 (September 8, 2005), available at www.charitylaw.ca, and Terrance S. Carter and Suzanne E. White "Tax Shelter Donation Schemes" *Charity Law Bulletin* No. 30 (December 16, 2003), available at www.charitylaw.ca.

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