
FEDERAL BUDGET 2007 HIGHLIGHTS FOR CHARITIES

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A. INTRODUCTION

The Federal Budget released on March 19, 2007, introduced a number of measures which will have a substantial impact on tax planning for charities and their donors. The federal government upheld its commitment from the 2006 Budget to remove the capital gains tax on publicly listed securities donated to private foundations, effective March 19, 2007, but imposed a new excess business holdings regime for private foundations. In addition, the 2007 Budget measures provide an incentive for corporations to donate medicines to charities for international distribution and modify already complicated rules related to gifts of private corporation shares and “loan-backs.”

B. EXTENSION OF ELIMINATION OF CAPITAL GAINS TAX TO PRIVATE FOUNDATIONS

In the 2006 Budget, the federal government completely eliminated the capital gains tax on gifts of publicly listed securities and ecologically sensitive land to charitable organizations and public foundations, indicating that it would consult with the charitable sector to develop appropriate self-dealing rules to safeguard against potential conflicts of interest before extending the measures to private foundations. After consultations and considerable lobbying by organizations, such as Philanthropic Foundations Canada, the Canadian Association of Gift Planners and Imagine Canada, the 2007 Budget proposes to eliminate the taxation of capital gains arising from donations of publicly-listed securities to private foundations. This measure will also be extended to donations of publicly-listed securities by an arm’s length employee who acquired the

security under an option granted by the employer and which will exempt the associated employment benefit from taxation.

C. NEW SELF-DEALING RULES

Existing government concerns that persons connected with a private foundation, by virtue of their and the foundation's combined shareholdings, may be able to exercise undue influence for their own benefit have been addressed in the 2007 Budget through the introduction of an excess business holdings regime for private foundations related to the intermediate sanctions introduced for charities in 2004. The proposed regime places limits on foundation shareholdings that take into account the holdings of persons not dealing at arm's length with the foundation.

The new excess business holdings rules will require a private foundation to continuously monitor its holdings and acquisitions of both publicly listed, as well as private corporation shares. Depending upon the amount of its interest in a particular class of shares of a company, a private foundation will be subject to varying requirements, as outlined below:

1. "Safe Harbour"

The new measures provide private foundations with a "safe harbour" of a 2 percent ceiling. Provided that the foundation's holdings in respect of each class of shares it holds in any one corporation does not exceed 2 percent of all outstanding shares of that class, the foundation will not be subject to any requirements under the new excess business holdings rules.

2. Monitoring and Reporting

If the foundation's holdings of one or more classes of shares of a company exceed 2 percent of all outstanding shares of that particular class, the foundation will be required to report to Canada Revenue Agency ("CRA") the amount of shares held at the end of the year of all classes in the corporation by the foundation, as well as by non-arm's length persons. For example, if a corporation has three classes of shares and the foundation holds 2 percent of the shares of one of the classes of shares, the foundation will be required to report to CRA the amount of shares it or a non-arm's length person has in each of the three classes of shares of that particular corporation. The foundation will also be required to report in its annual information return any material transactions (e.g. share transactions

involving more than \$100,000.00 or .5 percent of a class of shares) by the foundation or non-arm's length persons for any period during which the foundation was outside the safe harbour in respect of the corporation.

3. Divestment

If the foundation is outside the safe harbour range and the foundation and non-arm's length persons together hold more than 20 percent of the outstanding shares of a particular class of shares of a corporation, a divestment will be required and penalties will be imposed if the divestment does not occur within the time periods specified by the rules. The length of the period within which a foundation will be required to divest itself of excess shares will depend on the manner by which the excess arose:

- a) if the foundation purchased shares which would result in an excess at the end of the year, the foundation would be required to divest itself of the excess before the end of that year;
- b) if the excess was acquired as a result of an acquisition of shares by a non-arm's length person or by a donation to the foundation by a non-arm's length person, the foundation would be required to divest itself of the excess before the end of the subsequent taxation year;
- c) if the excess is the result of a donation from an arm's length party or a repurchase of shares by the corporation, the foundation would be required to divest itself of the excess before the end of the second subsequent taxation year; and
- d) if the excess is the result of a donation by way of a bequest, the foundation would be required to divest itself of the excess before the end of the fifth subsequent taxation year.

CRA will have the discretion to specify conditions under which it might defer the year of the divestment obligation upon application by the foundation, by up to five additional years in limited circumstances, such as where divestment of the shares within the normal compliance period would significantly depress the share price or where necessary to accommodate the requirements of securities regulators.

The following are examples of actions required by a foundation depending upon the percentage of shares held by the foundation:

	Private Foundation (Holdings of Share Class)	Non-Arm's Length Persons (Holdings of Share Class)	Action Required by a Foundation
1. Safe harbour	2% or less	Any percentage	None
2. Monitoring phase	5%	10%	Reporting required
	10%	10%	
	20%	0%	
3. Divestment required	25%	0%	Reduce holdings to 20%
	8%	14%	Reduce holdings to 6%*
	10%	17%	Reduce holdings to 3%*
	Above 2%	Above 18%	Reduce holdings to 2%*

Reproduced from Annex 5 of the Budget Plan, Department of Finance, 19 March 2007.

* Alternatively, non-arm's length persons could reduce their holdings until the combined holdings of the foundation and non-arm's length persons did not exceed 20%.

D. ADDITIONAL ISSUES RELATED TO THE NEW SELF DEALING RULES

The Federal Budget addressed a number of additional issues related to the new self dealing rules, including the following:

1. Non-arm's Length Persons

For the purposes of the new excess business holdings regime, the definition of non-arm's length persons as set out in section 251 of the *Income Tax Act* will apply. However, a person may be considered to be dealing at arm's length from the controlling person or member if the person is at least 18 years of age and living separate and apart from the controlling person or member, and the foundation applies to the Minister of National Revenue for a determination of this question of fact.

2. Exemption for Shares Made Subject to a Trust

Foundations will not be required to divest of shares donated before March 19, 2007, if the donation was made subject to a trust or direction that the shares be retained by the foundation and the terms of

the gift prevent the foundation from disposing of them. This will also apply to donations made on or after March 19, 2007 and before March 19, 2012, pursuant to the terms of a will signed or an *inter vivos* trust settled before March 19, 2007 and not amended after that date. However, these shares will be taken into account in determining the application of the excess business holdings regime to other shareholdings.

3. Proposed Penalty

A penalty will apply in respect of a foundation's excess business holdings that have not been divested as required. The proposed penalty is 5 percent of the value of excess holdings, increasing to 10 percent if a second infraction occurs within 5 years. Further, if a foundation is subject to such a penalty and has failed to provide information as required in respect of the particular shares, the penalty will be doubled.

4. Transitional Provisions and Other

The proposed excess business holdings rules also include provisions for public disclosure of information reported with respect to certain corporate shareholdings (except the names of non-arm's length persons), specific anti-avoidance measures, grandfathering rules related to existing donations and detailed transitional provisions. Generally, the transitional rules will allow foundations to divest, over a period of 5 to 20 years, excess business holdings existing as of March 18, 2007 at a rate of 20 percent every 5 years until the excess is eliminated. To encourage foundations with excess holdings to divest in a timely fashion, donations made to a foundation which has not completed its transition by the end of its first taxation year beginning after March 18, 2012 will be subject to tax on any capital gains resulting from the disposition.

E. NON-QUALIFYING SECURITIES

In another measure directed at perceived abuses involving private foundations, the Budget proposes to extend the rules related to donations of non-qualifying securities to structures involving a trust in respect of which the charity is a beneficiary. A non-qualifying security is a share in a corporation that the donor does not deal with at arm's length and whose shares are not listed on a prescribed stock exchange (private corporation shares) or a debt obligation (e.g., a promissory note) issued by a company or person that is not at arm's length to the donor. In order to ensure appropriate valuations for receipting purposes, donors of non-

qualifying securities to private foundations are generally not permitted a charitable donations credit or deduction unless the foundation disposes of the securities within five years of receipt or the security ceases to be a non-qualifying security (e.g. the shares become publicly-listed).

According to the Department of Finance, some donors have avoided these restrictions by transferring their private corporation shares into a trust in respect of which the charity is a beneficiary. A gift is recognized to the extent of the beneficial interest disposed of by the donor, yet the property remains under the control of the donor through the donor's control of the trust. It is proposed that, if the donor is affiliated with the trust, the same restrictions will apply as if the donor had donated the shares in his or her own name and a donation tax credit or deduction will be denied. This measure will apply to gifts made on or after March 19, 2007.

F. LOAN-BACKS

In a change which will apply to both private and public charities, the Department of Finance is proposing to amend the rules related to "loan-backs." Currently, the loan-back provisions in the *Income Tax Act* apply when a donor makes a gift to a qualified donee and within five years of the making of the gift the donee:

1. acquires a non-qualifying security from the donor; or
2. allows a donor who is not at arm's length to the charity, to use the charity's property within certain time frames.

In such instances, the donor has to reduce the eligible amount of the gift by the value of the property used, even if the donor is paying rent or giving the qualified donee something in exchange for the right to use the property.

According to the Department of Finance, some charities will accommodate arm's length donors who make their donations with the requirement that property be loaned back. The budget proposes to extend the loan back rules to include arm's length donors as well, applicable to gifts made on or after March 19, 2007.

G. GIFTS OF MEDICINES

The 2007 Budget also proposes to allow a special deduction for corporations that make donations of medicines from their inventory to registered charities that have received a disbursement under a program of the Canadian International Development Agency in respect of activities of the charity outside of Canada.

Currently, donations by corporations of property held in inventory are eligible for a charitable donation deduction equal to the fair market value of the property gifted. However, the economic impact of this donation is reduced by virtue of the requirement in subparagraph 69(1)(b)(ii) of the *Income Tax Act* to include the fair market value of the item in income. In order to provide an incentive for corporations to participate in international programs for the distribution of medicines, the Department of Finance is proposing to allow corporations that make donations of medicines from their inventory to claim a special additional deduction equal to the lesser of 50 percent of the amount, if any, by which the fair market value of the donated medicine exceeds its cost and the cost of the donated medicine. This measure will apply to gifts made on or after March 19, 2007.

H. CONCLUSION

Since the legislative details of these proposals have yet to be provided, their impact is difficult to assess at this time. However, since private foundations will now be subject to complicated excess business holdings rules, including public disclosure of share holdings for both public and private shares, private foundations that are designated as such may want to determine if they can qualify to be redesignated as either a public foundation or charitable organization. In any event, lawyers, accountants and gift planners who advise private foundations and who are involved in planning significant donations will now need to become conversant with the new rules in the recent Federal Budget, particularly the complicated new excess business holdings rules.