DONATION TAX SHELTERS INVOLVING FLOW-THROUGH SHARES

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A. INTRODUCTION

The impact of the elimination of the tax on capital gains accruing on donations of publicly-traded securities to charitable organizations and public foundations in 2006 as a result of the 2006 federal budget and to private foundations proposed in the 2007 federal budget, when coupled with tax incentives on flow-through shares issued by companies in the resource sector, has generated great interest and planning opportunities for investors in this sector.¹ The most recent form of donation tax shelters involves the donation of flow-through shares. This Charity Law Bulletin reviews the tax implications of donation tax shelters involving flow-through shares and concerns that charities and donors would need to be aware of when involved in such arrangements.²

B. DONATION TAX SHELTERS IN GENERAL

In general, tax shelters are arrangements that permit an investor to claim a tax deduction equal to a portion or even the entire amount of the investment within a short time period to create a loss in the current period from that particular source of income, and be able to reduce, therefore “shelter”, income taxes payable from other

¹ Tim Cestnick, “Flow-through mining shares can produce charitable bonanza” Globe and Mail (8 July 2006).
² A portion of this Bulletin is based on a paper by Karen J. Cooper and Theresa L.M. Man “Planned Giving for High Net Worth Clients” presented to the 2006 Ontario Tax Conference, October 16, 2006.
sources of income. Originally, tax shelters usually involved investments in aircraft, movies, scientific research, resource exploration and development, and computer software. As the ability to claim tax benefits from these tax shelter arrangements reduced over the years due to changes to the *Income Tax Act (Canada)* (the “Act”), tax shelters gradually evolved to involve charitable donations of gifts-in-kind and leveraged charitable donations. Early donation arrangements involved donation of artwork. Later, donation of other property was involved, such as comic books, figurines, plates, stamps, jewellery, medical supplies, computer programs, educational products, food (such as rice, beans, barley grass) clothing and pharmaceutical products. Common forms of these donation tax shelters involve “buy-low donate-high” tax shelters, gifting trust arrangements and leveraged charitable donation arrangements. Both the Department of Finance and Canada Revenue Agency (“CRA”) have been attempting to shut down abusive tax shelter donation arrangements with various amendments to the Act since 2003, and reassessing taxpayers involved with such donation tax shelters.

C. DONATION OF FLOW-THROUGH SHARES

The most recent form of donation tax shelters involves the donation of flow-through shares. Flow-through shares are tax-based financing incentives available to the oil and gas, as well as the mining sectors. In the 1990s, the mining and resource industry experienced low mineral prices and therefore a downturn in exploration. As a result, the government introduced an incentive to promote exploration to assist those industries to raise equity through flow-through shares.

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5 These amendments are embodied in a package of proposed amendments first introduced by Finance on December 20, 2002. These amendments have since undergone various incarnations on December 5, 2003, February 27, 2004 and July 18, 2005. New consolidated changes were released by the Department of Finance on November 9, 2006 by way of a Notice of Ways and Means of Motion. The motion was introduced as Bill C-33, and received its first reading in the House of Commons on November 22, 2006, and second reading on May 14, 2007, as the *Income Tax Amendments Act, 2006*.

6 For a discussion on the status of draft legislative amendments made to curtail tax shelter arrangements, the consequences of non-compliance with the proposed changes, their impact on those involved in donation tax shelters, and various steps taken by Canada Revenue Agency to shut down abusive donation tax shelters schemes and their effectiveness, see paper by Theresa L.M. Man, “Tax Shelters and Charitable Donations – a Miss-Match,” July 4, 2006 at [www.charitylaw.ca](http://www.charitylaw.ca).
The current rules effectively permit corporations to renounce or “flow-through” income tax deductions associated with certain activities to shareholders in exchange for the sale of their shares.\(^7\) A flow-through share is generally a financing arrangement whereby an investor/shareholder will invest in exploration by providing funds to a corporation that uses them to incur Canadian exploration expenses, Canadian development expenses or Canadian oil and gas property expenses. The investor receives shares issued by the corporation as consideration and the deductions available to the corporation in relation to these resource expenditures are flowed-through to the shareholders who have provided the funding for the expenditures.\(^8\) The expenditures deducted by the investor reduce the cost base of the shares held. Once the exploration is complete, investors typically exchange the flow-through shares for normal securities of the issuer (on a tax deferred basis). Since flow-through shares are generally deemed to have an adjusted cost base of nil,\(^9\) a significant capital gain will normally occur when the securities are sold.

The impact of the elimination of the tax on capital gains accruing on donations of publicly-traded securities to registered charities, when coupled with tax incentives on flow-through shares issued by companies in the resource sector, has generated great interest and planning opportunities for investors in this sector. In this regard, in the 2006 federal budget, the federal government completely eliminated the capital gains tax on certain gifts of publicly-traded securities to charitable organizations and public foundations.\(^10\) Subsection 38(a.1) was amended to provide that no portion of the capital gain in respect of such gifts, made after May 1, 2006, would be included in computing the donor’s taxable capital gains. As a result, donors would not be taxed on any of the capital gain accrued on the donated property and would receive the full benefit of the donation tax credit on the donation.\(^11\) In the 2007 federal budget, the federal government extended the elimination of the capital gains tax on publicly-traded securities donated to private foundations, effective March 19, 2007.\(^12\) At the time of writing, technical amendments to the Act to put into effect the proposed changes contained in the 2007 federal budget in relation to the exemption of the capital gains tax on the donation of publicly-traded securities to private foundations has not been released.

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\(^7\) Subsection 66(12.6) of the Act.
\(^9\) Subsection 66.3(3) of the Act.
\(^10\) As well as the donation of ecologically sensitive land.
It is important to note that the incentives for donations of flow-through shares only work in relation to those shares that are publicly-listed. One of the ways that the government has attempted to curtail donation tax shelters is to ensure that the fair market value of the donated property is accurate. The newly proposed subsection 248(35) of the Act introduces a new provision that generally applies to gifts made after December 5, 2003 and which deems the fair market value of the donated property to be equal to the cost of the property to the donor under certain circumstances. However, the deeming provision does not apply to donation of, *inter alia*, publicly-traded shares.\(^{13}\)

Assume that an investor, instead of purchasing non-flow-through shares, acquires $1,000 of flow-through shares of a publicly-listed corporation. Over the course of the exploration period, the investor will be entitled to $1,000 in flow-through deductions related to the exploration expenses resulting in tax savings of about $460 (assuming a 46% marginal tax rate) and reducing the adjusted cost basis of the shares to nil. At this point, the $1,000 flow-through shares will have effectively cost only $540. When exploration is completed and the investor has claimed the maximum possible amount of exploration deductions, the shares may be gifted to a qualified donee. Assuming that the value of the shares remains $1,000, the investor will be entitled to a federal donation tax credit in respect of the $1,000 donation of $262, which results in another tax savings of about $460, and will not be taxed on the capital gain. As a result, the investment and, thereafter, donation to charity of $1,000 will only cost the investor/donor $80.\(^{14}\)

In situations where the donation of flow-through shares is made through the use of private corporations, it might result in additional tax savings. The amount in a private corporation’s capital dividend account (“CDA”) may be paid to its shareholders on a tax-free basis as dividends.\(^{15}\) The CDA may be increased by the non-taxable portion of any capital gains. Since donation of flow-through shares to registered charities by a private corporation would not be subject to capital gains tax, the full value of the flow-through shares donated would be non-taxable (assuming that the adjusted cost basis has been reduced to nil). As such, the CDA of the private corporation would be increased by the same amount, and therefore be available to be distributed as tax-free dividends to its shareholders. Therefore, it is possible for an investor to cause his private corporation to acquire and donate flow-through shares to a charity, and receive tax-free dividends.

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13 Paragraph 248(37)(d) of the Act.
14 CRA has considered a donation of flow-through shares, but did not rule on the tax consequences of the donation (CRA Advance Income Tax Ruling, document number 2003-002905).
15 See definition of “capital dividend account” in subsection 89(1) of the Act.
from the private corporation’s CDA. Alternatively, it is possible for the investor to acquire the flow-through shares himself/herself, and enjoy the benefit of tax benefits of the “flow-through” deductions personally. When exploration is completed and the investor has claimed the maximum possible amount of exploration deductions, instead of donating the flow-through shares directly to a charity, the investor may rollover the flow-through shares to his/her private corporation on a tax-free basis under section 85 of the Act. The private corporation would then donate the shares to a charity and avail itself of the charitable deduction from the donation receipt issued by the charity to reduce the tax payable by the private corporation. At the same time, the CDA of the private corporation would be increased by the same amount, and tax-free dividend distributions from the CDA may be made to the investor/shareholder.

Returning to the example above, after the individual has claimed the maximum possible exploration deduction and exploration is complete, the shares are rolled into a private corporation at their adjusted cost base of nil. The private corporation donates the shares and claims a federal donation in tax credit and results in a tax savings of about $460 and includes $1,000 in its CDA and can pay a tax-free dividend of that amount to its shareholder.

The foregoing is an explanation of the simpler structures developed in the market. Structures involving flow-through shares are evolving and becoming increasingly complex. The tax consequences outlined in this Bulletin are based on a number of assumptions which may not always apply to a particular structure and charities and investors/donors should always obtain competent professional advice before contemplating involvement in such structures.

D. CONCERNS FOR CHARITIES AND DONORS

Even though it would appear that the donation of flow-through shares could result in attractive tax savings to the donors and large donations to charities, such donations are not without concerns to donors and the charitable sector. Some of the issues that charities and investors/donors should consider before getting involved are summarized below.

1. Correct Donation Receipt

It is important for charities to ensure that the receipts issued in respect of flow-through shares received are accurate. First, charities have the duty to exercise due diligence when issuing charitable donation receipts to
ensure that the information on the receipts is accurate. Failure to issue receipts reflecting the accurate eligible amounts may lead to charities being exposed to intermediate sanctions that were proposed by the 2004 federal budget and implemented in 2005\textsuperscript{16} for issuing incomplete receipts\textsuperscript{17} or false receipts,\textsuperscript{18} or may even lead to the revocation of their charitable status. In this regard, subsection 248(41) provides that if a donor fails to provide the charity with relevant information\textsuperscript{19} that may cause the eligible amount of the gift to be less than the fair market value of the property gifted, then the eligible amount of the gift would be deemed to be nil. Second, a charity must be careful in ensuring that the eligible amount of a receipt reflects the accurate true value of the donation received in order not to negatively impact the ability of the charity to meet its disbursement quota. The amount for which the receipt is issued is included in the charity’s disbursement quota requirement for the following year. If a charity issued a receipt for an inflated amount and later sold the property for an amount far below the amount for which the receipt was issued, the charity may have a shortfall in meeting its disbursement quota. Failure to meet the disbursement quota is grounds for the revocation of a charity’s registered status.\textsuperscript{20}

2. Advantage

New proposals to the \textit{Income Tax Act} permit a donor to receive an “advantage” (i.e. a benefit in return), provided that the value of the property donated by the donor exceeds the amount of advantage received by the donor, and that the value shown on the donation receipt reflects the difference between the fair market value of the gift and the amount of the advantage. In this instance the eligible amount of the gift\textsuperscript{21} would be the fair market value of the donation, less the amount of any advantage\textsuperscript{22} received by the donor in respect of the donation. The proposed provision defines “advantage” broadly but is contingent on the benefit being:

\begin{footnotes}
\footnotemark[17] A 5% penalty tax of the amount shown on the receipt, increased to 10% upon repeat infractions within five years pursuant to subsection 118.1(7) and (8) of the Act.
\footnotemark[18] Subsection 188.1(9) of the Act imposes a penalty equal to 125% of the amount shown on a receipt if it contains a false statement. See also Canada Revenue Agency, \textit{Information Circular IC 01-1}, “Third-Party Civil Penalties,” September 18, 2001 commentary to example 8, where CRA indicated that “[i]f the charity knew, or would have reasonably been expected to know but for circumstances amounting to culpable conduct, that the valuations were incorrect, it would be liable for the penalties for issuing false receipts.”
\footnotemark[19] The donor is required to provide information to the charity regarding subsection (31), (35), (36), (38) or (39) of the Act.
\footnotemark[21] According to a proposed definition found in subsection 248(31) of the Act.
\footnotemark[22] See proposed definition found in subsection 248(32).
\end{footnotes}
(i) consideration for the gift or monetary contribution,  
(ii) in gratitude for the gift or monetary contribution, or  
(iii) that is in any other way related to the gift or monetary contribution.

The Department of Finance, in the Technical Notes accompanying the proposed amendments, noted that the tax benefit arising from the donation tax credit or deduction would not be considered an advantage for the purposes of the definition in subsection 248(32). However, it is not clear whether the tax benefits arising as a result of the renounced exploration expenses or the investment tax credit may constitute an advantage which would reduce the value of the receipt. In this regard, CRA has considered whether the value of the receipt on a donation of flow-through shares should be reduced in these circumstances and concluded that it should not. The basis for this position, in part, is a line of cases which led to the proposed amendments which found that the tax benefit resulting from a gift should not be considered a benefit which would nullify the gift.

3. Hold Periods

Many flow-through shares are subject to hold periods. If a charity received flow-through shares that are subject to a hold period and possible other restrictions, it would not be permitted to sell and liquidate the flow-through shares until the end of the hold period. As such, it would be necessary for the charity to review a number of issues in this regard. For example: whether the length of the hold period is reasonable, whether the flow-through shares would retain their value at the end of the hold period, and whether the flow-through shares would be marketable at the end of the hold period.

4. Valuation

If the flow-through shares may not be sold by the charity for a period of time, this brings into question what would be the accurate value of the eligible amount of the gift on the receipt. Because the Act does not provide guidance in determining how a gift of shares should be valued, CRA has, as a general rule, accepted the use of the closing bid price of the share on the date it is received or the mid-point between the high and the low trading prices for the day, whichever provides the best indicator, given the circumstances, of fair market value on normal and active market trading. However, a careful review of the facts of each situation

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23 This consideration occurred in the context of a request for an advanced income tax ruling which was never provided. However, the draft ruling which was circulated took this position and, while that ruling is not binding on the CRA, there is no reason to believe that they would take a different position.

24 CRA, Registered Charities Newsletter No. 12 (Spring 2002) (online: http://www.cra-arc.gc.ca/E/pub/tg/charitiesnews-12/news12-e.html. See also paragraph 3702(1)(b) of Income Tax Regulations. Furthermore, it is important for the purposes of valuation to determine the date of the gift of publicly traded shares. On that issue, see paper by Karen J. Cooper and Theresa L.M. Man, supra note 2.
would need to be made to determine the “fair market value” based on many factors, including the size of the block of shares in relation to the whole, the volume traded, the attributes of the shares, whether the donor had control or was a minority shareholder, whether there were any restrictions on the transferability of the shares, and whether the shares were thinly traded, requiring a look at trades over a longer period of time. If the flow-through shares may not be sold by the charity for a period of time, the general rule of using the trading price may not be an accurate reflection of the eligible amount of the receipt to be issued by the charity. As such, it might be necessary for the charity to obtain an independent appraisal of the value of the flow-through shares, taking into account of the restrictions that the flow-through shares are subject to.

5. **Prudent Investment**

If the charity is required to hold the flow-through shares for a period of time, it also brings into question whether the ownership of the flow-through shares during the hold period is an appropriate investment that complies with the applicable trustee legislation. For example, in Ontario, the 1999 amendments to the *Trustee Act* (Ontario) established a prudent investment standard governing investment decision-making of trustees or board of directors of charities. Therefore, before the directors accept an investment on behalf of the charity, they must be satisfied that the investment made meets the prudent investment test set out in the *Trustee Act*.

6. **Carrying on a Business**

With the expansion of the elimination of capital gains tax of publicly-traded securities to private foundations, it is possible for an investor/donor to donate flow-through shares to a private foundation. However, one of the many restrictions that private foundations are subject to is that they cannot carry on any business activities. If the investment of the flow-through shares is in the form of an investment in units of a limited

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25 Subsection 27(5) of the Trustee Act states that a trustee must consider the following criteria in the planning of investment of trust property, in addition to any others that are relevant in the circumstances:

- general economic conditions;
- the possible effect of inflation or deflation;
- the expected tax consequences of investment decisions or strategies;
- the role that each investment or course of action plays within the overall trust portfolio;
- the expected total return from income and the appreciation of capital;
- needs for liquidity, regularity of income and preservation or appreciation of capital;
- an asset’s special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

In addition to the said mandatory investment criteria, subsection 27(6) of the Trustee Act states that a trustee must diversify the investment of trust property to an extent that is appropriate to:

- the requirements of the trust; and
- general economic and investment market conditions.

26 Paragraph 149.1(4)(a) of the Act.
partnership, and if what is donated to the charities is units in the limited partnership, then such a donation could only be made to charitable organizations or public foundations, but not private foundations. This is because a limited partner of a limited partnership is deemed to be carrying on the partnership business and therefore a charity holding units in a limited partnership is considered by CRA to be carrying on a business, something that a private foundation is prohibited from engaging in. A private foundation carrying on business activities may run the risk of being subject to an intermediate sanction of penalty tax or even revocation of charitable registration.

7. Tax Shelter Identification Number

Flow-through shares are not new and the purchase and sale of flow-through shares by themselves are generally not tax shelters. However, when the purchase of flow-through shares is promoted together with making a gift to a charity, it would generally qualify as a “gifting arrangement” described in subsection 237.1(1) of the Act, and thereby may be required to obtain a tax shelter identification number. Charitable donation arrangements embodied within the definition of gifting arrangement are required to be registered with CRA and comply with all tax shelter reporting requirements. Investors have to provide the tax shelter identification number to CRA before they can claim any tax credit or tax deductions in respect of the tax shelter. Therefore charities and donors would need to ensure that any flow-through share arrangement that they are involved in, that meets the definition of a gifting arrangement, should be registered with CRA.

However, it is important for donors and charities to understand that the purpose of requiring gifting arrangements to be registered, is to allow CRA to be able to identify and track unacceptable donation tax shelters pursuant to subsection 237.1(8). CRA has been warning the public that the issuance of a tax shelter identification number does not indicate that CRA “guarantees an investment or authorizes any resulting tax benefits,” and that CRA “only uses this identification number later to identify unacceptable tax avoidance

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29 Including registering and obtaining a tax shelter identification number, filing an annual information return (T5002) and tax shelter information supplementaries, T5003 (including the name, address and social insurance number of each investor, and the amount paid by each investor).
arrangements.” It has been pointed out that in spite of the repeated warnings by CRA, many people will still think that they’re safe in buying these tax shelters because (1) the tax shelter has a CRA identification number, and (2) they actually receive a refund in respect of their investment in the tax shelter. The potential misunderstanding is expected to be more serious in ethnic communities in Canada where English is not their first language and where they rely entirely on the representations and advice of the promoters and advisors.

8. Charities as Promoters

Charities are usually not considered “promoters” of tax shelters. However, it is possible that a charity may be deemed to be a promoter of a tax shelter in some situations. “Promoter” is defined in subsection 237.1(1) of the Act to be a person who in the course of a business (a) sells or issues, or promotes the sale, issuance or acquisition of, the tax shelter, (b) acts as an agent or adviser in respect of the sale or issuance, or the promotion of the sale, issuance or acquisition, of the tax shelter, or (c) accepts, whether as a principal or agent, consideration in respect of the tax shelter. It is possible for there to be more than one promoter in respect of a tax shelter. If a charity is recognized by CRA to be promoting a tax shelter aggressively or promoting a shelter in the course of carrying on a business, then the charity may be deemed to be a promoter of a tax shelter. As such, charities should be careful about their involvement in tax shelters in order to avoid inadvertently becoming deemed to be tax shelter promoters.

9. Tracking Gifts of Flow-Through Shares

Where charities receive donations of publicly-traded securities, they must be carefully identified whether they are flow-through shares or other publicly-traded securities. Where flow-through shares are received, these gifts must be carefully tracked and monitored, and liquidated as soon as possible, in order to avoid inadvertently holding the flow-through shares as though they are regular publicly-traded securities.


A tax shelter number is used for identification purposes only. It enables the CRA to identify all tax shelters and their investors but offers no guarantee that taxpayers will receive the proposed tax benefits. The CRA reviews all tax shelters to ensure that the tax benefits being claimed meet the requirements of the Income Tax Act. [Emphasis in original]

A similar warning is contained in CRA’s Taxpayer Alert, November 22, 2005.

32 See for example Tim Cestnick, “Donation tax schemes can come back to bite you in three years,” Globe and Mail, December 11, 2004. See also CRA technical interpretation 2006-0197051C6, October 6, 2006 (French).
10. **Representations and Professional Opinions**

Where tax shelter materials contain representations regarding the potential tax savings of donation of flow-through shares, the value of the flow-through shares, the marketability of the flow-through shares, restrictions on the sale of the flow-through shares, care must be exercised to ensure the accuracy of those representations. Further, legal and accounting opinions provided by promoters should also be reviewed carefully.

11. **CRA Draft Rulings**

Where tax shelter promoters provide draft rulings by CRA, they cannot be relied upon. It is important to note that CRA clarified in a recent technical interpretation[^33] that it does not issue draft rulings for circulation purposes. In that case, a draft ruling was sent to the taxpayer for the sole purpose of verifying that the facts and proposed transactions were correctly stated. At the time when the draft ruling was issued, CRA was of the understanding that additional information was to be provided to CRA. The information requested by CRA was not provided. The taxpayer used the draft ruling as a marketing tool and such use was unacceptable to CRA. The taxpayer was advised to cease making reference to the draft ruling, because no binding ruling had been issued by CRA in respect of the proposed transaction and “to suggest otherwise would be providing a claim that is unfounded.”

12. **Other Possible Penalties and Consequences for Non-Compliance**

In addition, other than CRA actively reassessing taxpayers involved in unacceptable donation tax shelters to reduce or disallow tax credits or deductions claimed, other penalties may be imposed on taxpayers; third-party penalties may be imposed on promoters, appraisers, charities, preparers, advisors, registered charities and registered Canadian amateur athletic associations; penalties and other sanctions may be imposed on promoters; as well as revocation of the charitable status of charities involved.[^34] This month, CRA a warning for circulation to the charitable sector and donors, reiterating CRA’s concerns with respect to the involvement of charities in abusive or fraudulent donation tax shelters, the intention of CRA to aggressively

[^34]: See paper by Theresa Man, supra note 6.
challenge such arrangements, and the possibility of imposition of “significant penalties” against such charities and revocation of their charitable status.\(^{35}\)

**E. CONCLUSION**

The attractiveness of the donation of flow-through shares is premised upon two tax policies of the Canadian government, namely an incentive to encourage investments in the mining and resource industry, as well as an incentive to encourage donations of publicly-traded securities to registered charities to allow them to engage in good work for the society. As long as the federal government continues to uphold these two tax policies, it would appear that the donation of flow-through shares might result in a win-win situation for both donors and charities, provided that donors and charities exercise due diligence in addressing the concerns mentioned in this Bulletin.

Donors and charities which anticipate being involved in making and receiving gifts of flow-through shares respectively would need to exercise caution in addressing the above-noted concerns in relation to the particular arrangements presented to them. Charities which have not developed a policy in respect of receipt of donations of publicly-traded securities should do so at their earliest opportunity, taking into consideration the guidance provided in *Registered Charities Newsletter* No. 12. Generally, such a policy should address issues involving how gifts of publicly-traded securities may be received, how such gifts are to be valued, how to address the various concerns mentioned in this Bulletin, as well as, where necessary, circumstances the organization might refuse to accept such a gift for example, where the business or activities of the corporation conflict with objects and values of the organization.

\(^{35}\) A copy of the warning issued by CRA is available on our website at [www.charitylaw.ca](http://www.charitylaw.ca).

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