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CHARITY LAW BULLETIN NO. 184

Carters Professional Corporation / Société professionnelle Carters
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DECEMBER 18, 2009
Editor: Terrance S. Carter

TAX COURT OF CANADA DENIES LEVERAGED DONATION TAX CREDIT

By Karen J. Cooper[*]

A. INTRODUCTION

On November 12, 2009, the Tax Court of Canada ("TCC") released its decision in *Maréchaux v. The Queen*.[1] The decision relates to an appeal by a taxpayer from an assessment made under the *Income Tax Act* ("ITA")[2] in which a tax credit claimed by the taxpayer in respect of a purported $100,000 gift to a registered charity was disallowed in its entirety. The decision is significant because it is one of the first dealing with a leveraged donation gifting arrangement from the donor's perspective.

Leveraged cash donations are one form of tax shelter gifting arrangement that has been flagged by the Canada Revenue Agency ("CRA"). In such arrangements, a taxpayer receives a pre-arranged loan and makes a donation of the loan proceeds plus additional cash to a registered charity. The taxpayer is not at risk for the loan and the charity must use the proceeds in a predetermined manner.

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[1] 2009 TCC 587.
[2] R.S.C. 1985, c. 1 (5th Supp.) as amended.

CRA has issued several Taxpayer Alerts warning taxpayers that it intends to audit tax shelter gifting arrangements, including leveraged cash donations. Every such audit completed to date has resulted in a reassessment of taxes, plus interest and in some cases the CRA has denied the gift completely.[3]

B. FACTS

The appellant in *Maréchaux* was one of 118 participants in an arrangement known as the 2001 Donation Program for Medical Science and Technology (the "Program), marketed by Trinity Capital Corporation (the "Promoter"). The Program was advertised as providing a return on donation of up to 62.4 percent, depending on the donor's province of residence. The promotional materials also promised no alternative minimum tax consequences and a tax opinion from a firm of respected tax lawyers.

The participants in the Program each donated a minimum of $100,000 to a registered charity, the majority of the donation being financed by a non-interest bearing 20-year loan. The promoter of the Program arranged for each participant to borrow these funds from a lender that had been created for the sole purpose of providing loans for the Program. Participants were also required to pay an amount equal to 10% of their pledge to the lender for fees, insurance and a security deposit. A crucial feature of the loan was that it could be fully repaid by assigning the insurance policy and security deposit to the lender any time after January 15, 2002 (the "Put Option"). The funds were transferred to the charity, which issued donation receipts in the full amount of the transferred funds. Most of the participants then claimed charitable donation tax credits for their 2001 taxation year and went on to satisfy their loans by assigning their security deposits and insurance policies to the lender.

The remainder of the Program involved a series of interrelated transactions among several different entities. The Promoter directed the charity to distribute the majority of the donated funds to two other qualified donees, which in turn spent the funds in a pre-determined manner. In the end, the charities involved in the Program retained only a very small amount of the donated funds.

On December 31, 2001, the appellant taxpayer participated in the program to the extent of the minimum donation of $100,000. The appellant received an $80,000 non-interest bearing loan, $70,000 of which was added to $30,000 of his own funds and transferred to a charity. The remaining $10,000 of the loan was paid

[3] Canada Revenue Agency, Taxpayer Alert: "Warning: Participating in tax shelter gifting arrangements is likely to result in a tax bill!" August 13, 2007.

to the lender for fees, insurance and a security deposit. The appellant then received a donation receipt from the charity in the amount of $100,000.

In a reassessment for the 2001 taxation year, the tax credit in respect of the appellant's $100,000 donation was disallowed in its entirety. The appellant served a notice of objection to the assessment and subsequently filed an appeal to the Tax Court of Canada.

C. DECISION

The TCC's decision turned on whether the $100,000 donation could be considered a gift. If the donation was not a gift, the $100,000 could not be included in the calculation of the taxpayer's charitable donation tax credit. Section 118.1 of the ITA provided at the time for a tax credit to individuals based on the total amount of gifts made to registered charities and other listed organizations. This tax credit was calculated based on the "total charitable gifts" of an individual for a taxation year, which is defined in subparagraph 118.1(1). However, the ITA does not define the term "gift." The TCC examined briefly how the general meaning of the word gift has been expressed in case law, including the definition of "gift" that was provided in *The Queen v. Friedberg*:[4] "a gift is a voluntary transfer of property owned by a donor to a donee, in return for which no benefit or consideration flows to the donor."

The TCC applied the *Friedberg* definition to the facts of the appeal and stated "it is clear that the appellant did not make a gift to the [charity] because a significant benefit flowed to the appellant in return for the donation."[5] The benefit received by the appellant was the $80,000 loan, coupled with the Put Option. The Court found that the loan was given in return for the donation and that the financing and the donation were "inextricably tied."[6] In the Court's view, "it is self evident that an interest-free loan for 20 years provides a considerable economic benefit to the debtor."[7] The court also noted that the $8,000 security deposit, which was assigned to the lender in full satisfaction of the loan, could not reasonably be expected to accrete to anywhere near $80,000 in 20 years. The appellant attempted to argue that his participation in the Program was primarily for charitable reasons and presented evidence of his past charitable works and giving. The TCC rejected this argument, stating "[O]nce it is determined that the appellant anticipated to receive, and did

[4] 92 DTC 6031(FCA), at 6032.
[5] *Maréchaux*, *supra* note 1at para. 32.
[6] *Ibid.*, para. 33.
[7] *Ibid.*, para. 35.

receive, a benefit in return for the Donation, there is no gift."[8] Therefore, the appeal was dismissed and the TCC ruled that the tax credit for the entire amount was properly disallowed.

Although the point was not argued, the TCC also addressed the issue of whether the appellant made a partial gift, consisting of his own cash outlay. The court noted that "in some circumstances, it may be appropriate to separate a transaction into two parts, such that there is in part a gift, and in part something else."[9] However, the court decided such a separation was not appropriate in this matter.

D. LEGISLATIVE AMENDMENTS

Since the transactions at issue in *Maréchaux*, proposed changes to the ITA related to split-receipts and donation tax shelters have significantly changed how these transactions would be treated on an assessment, though the results could potentially remain the same. New subsections 248(30) to (41) are proposed to be inserted in the Act to allow a donor to receive a donation tax receipt even in situations where the donor or someone else received a limited advantage as a result of the gift.[10] Under the proposed amendments donors are permitted to receive something in return for a donation provided the amount of the donation is reduced by the amount of any advantage received by the donor and a receipt is only issued for the eligible amount of the gift. Subsection 248(31) provides that the "eligible amount" of a gift is the amount by which the fair market value of the property transferred exceeds the amount of the advantage in respect of the gift. A broad definition of "advantage" is set out in subsection 248(32) of the Act. These changes generally apply to gifts made after December 20, 2002, with a few exceptions.

Several proposed amendments introduced in December 2003 were designed to reduce the tax benefits available from charitable donations made under tax shelter gifting arrangements. With the addition of paragraph 248(32)(b), the proposed definition of advantage includes the amount of limited-recourse debt incurred in respect of a gift at the time when the gift is made, as determined pursuant to the newly introduced definition of limited recourse debt in proposed subsection 143.2(6.1). The purpose of these proposed amendments was to curtail abusive tax shelter schemes involving leveraged donations.[11] The amendments

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[8] *Ibid.*, para. 42.
[9] *Ibid.*, para. 48.
[10] These amendments were first introduced as part of Draft Technical Amendments to the ITA released on December 20, 2002. After a series of changes and revisions, the proposed amendments were reintroduced in Bill C-10 which was under review until it died on the Order Paper on September 7, 2008, as a result of the dissolution of the Parliament. These amendments have not been re-introduced in Parliament for enactment. CRA has indicated that they are applying these provisions as if enacted.
[11] Department of Finance News Release 2003-061 (December 5, 2003).

apply to gifts made on or after February 19, 2003. The cumulative effect of paragraph 248(32)(b) and subsection 143.2(6.1) is to reduce the amount of the gift made by the donor by the amount of the loan borrowed if the indebtedness is of limited recourse to the lender or if there is a "guarantee, security or similar indemnity or covenant" in respect to that debt or any other debts. The Department of Finance noted that debt incurred as part of a leveraged cash donation will be considered to be limited-recourse debt if it is to be repaid under an arrangement such as a guarantee, security, or similar indemnity or covenant in respect of the debt structured as part of the donation arrangement, structures seemingly very similar to those in the Program at issue in *Maréchaux* although we have not reviewed the actual Program documents.

Proposed subsection 248(34) deals with the repayment of limited recourse debt. This subsection generally provides that a repayment of the principal amount of a limited-recourse debt in respect of a gift is deemed to be a gift in the year it is paid. However, in some situations, the total amount of limited-recourse debt and other advantages to the donor may exceed the fair market value of the property transferred to the charity, thereby resulting in no eligible amount being available to the donor. In such cases, the donor would need to pay off the excess amount before any amount will be allowed as a gift. The Technical Notes to this provision explains that "a payment financed by other limited-recourse debt or made by way of assignment or transfer of a guarantee, security or similar indemnity or covenant is not recognized for these purposes." Examples in this regard include "the assumption of a taxpayer's limited-recourse debt by another person, in exchange for an insurance policy in favour of the taxpayer that guarantees a particular rate of return on an investment held by any person, would not qualify as a deemed gift under subsection 248(34)."[12]

At common law, in order to qualify as a gift, property must be transferred voluntarily with an intention to make a gift. Where the transferor has received any form of consideration or benefit, it is generally *presumed* that such an intention is not present. However, subsection 248(30) provides that the existence of an advantage in respect of a property transferred to a qualified donee (e.g. a registered charity) does not "in and of itself" disqualify the transfer from being a gift under two situations, namely (a) where the amount of the advantage does not exceed 80% of the fair market value of the transferred property and (b) where the transferor establishes to the satisfaction of the Minister of National Revenue (the "Minister") that the transfer was made with the intention to make a gift. Under the latter scenario, the Technical Notes indicate that the

[12] Department of Finance, Technical Notes released February 18, 2008.

taxpayer would need to apply to the Minister for a determination of whether the transfer was made with the intention to make a gift.

Notwithstanding the fact that these amendments have fallen off the legislative agenda and have not been enacted, CRA already requires charities to comply with the proposed split-receipting rules and its administrative positions have been upheld by courts. Therefore, any leveraged donations made on or after February 19, 2003 will be dealt with on the basis of the proposed amendments.[13]

E. COMMENTARY

Had the transaction at issue in *Maréchaux* occurred after February 19, 2003, the $100,000 gift would have to be reduced by the value of the limited-recourse debt incurred in respect of the donation plus any other advantages received by the donor. In addition, if donative intent cannot be established in accordance with subsection 248(30), i.e. if the amount of the advantage exceeds 80% of the transferred funds, the gift may be disallowed entirely. It could be argued that some of the legislative changes directed at leveraged donations were not necessary given the Court's reasoning in *Marechaux*. However, it is clear that since the release of the proposed amendments many, if not all, similarly structured programs have disappeared, providing certainty to taxpayers that might not have otherwise been there in the interim.

[13] Although these proposed changes have not been enacted, Canada Revenue Agency ("CRA") released Technical News No. 26 on December 24, 2002, concerning proposed new rules for split-receipting which is premised on these proposed changes. Furthermore, the British Columbia Supreme Court in *Richert* v. *Stewards' Charitable Foundation* [2005] B.C.C.J. No. 279 up-held compliance with Technical News No. 26, as required by CRA. In this regard, CRA's Registered Charities Newsletter No. 17 specifically indicates that the proposed guideline in Technical News No. 26 "can be relied on now, despite the fact that the proposed legislation is not yet law." For details, please refer to the following Charity Law Bulletins available on our website at www.charitylaw.ca:

- *Charity Law Bulletin* No. 23, "New CCRA Guidelines on Split-Receipting," dated July 22, 2003; and
- *Charity Law Bulletin* No. 68, "B.C. Court Upholds CRA Guidelines on Split-Receipting," dated April 7, 2005.

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