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DRAFT LEGISLATIVE PROPOSALS AFFECTING CHARITIES AND RCAAAS

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A. INTRODUCTION

On July 31, 2015, the Department of Finance released draft legislative proposals ("Proposals") to amend the *Income Tax Act* ("ITA") for consultation to implement certain tax measures from the April 21, 2015 Federal Budget ("Budget 2015") affecting charities and registered Canadian amateur athletic associations ("RCAAAs").[1] Among other changes, the Proposals would provide an exemption from capital gains tax for certain dispositions involving private corporation shares or real estate where cash proceeds are donated to a qualified donee within 30 days. The Proposals would also allow registered charities and RCAAAs to acquire or hold interests in limited partnerships. Interested parties may provide comments to the Proposals by September 30, 2015.

The Proposals follow the enactment of Bill C-59, *Economic Action Plan 2015 Act, No. 1* which implemented some of the measures concerning the charitable and not-for-profit sector introduced in Budget 2015. Bill C-59 received royal assent of June 23, 2015. In particular, Bill C-59 amends subsection 149.1(26) and the definition of "qualified donee" in subparagraph 149.1(1)(a)(v) to clarify that both foreign charitable organizations and foundations are eligible for registration as qualified donees under the

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[1] Department of Finance Canada, "Department of Finance Consults on Draft Legislative Proposals", (Ottawa: DOF 31 July 2015) online: http://www.fin.gc.ca/n15/15-073-eng.asp.

ITA. See "Federal Budget 2015: Impact on Charities" in *Charity Law Bulletin* No. 363, for further discussion of proposed amendments of Budget 2015.[2]

B. MEASURES TO EXEMPT CAPITAL GAINS ON DONATIONS OF PROCEEDS OF SALE OF PRIVATE SHARES AND REAL ESTATE

One of the welcomed changes introduced in Budget 2015 is to provide an exemption from capital gains tax in respect of donation of proceeds of sale from arm's length dispositions of real estate or private corporation shares, subject to anti-avoidance measures. The new rule will apply to 2017 and subsequent taxation years.

The explanatory notes to the Proposals indicate that anti-avoidance measures are necessary to address concerns including a heightened risk of self-dealing, unreasonable valuations, or tax planning being used to access the tax benefits of this proposal and other tax benefits in ways that are not intended. The types of property that are eligible for this exemption are often illiquid and difficult to value; generally closely-held by families or small groups of individuals; and tax attributes associated with transactions involving these types of property are complex.[3] The explanatory notes also indicate that the government will continue to monitor the effectiveness of the measure and take appropriate action to address such tax planning, as required.

Specifically, the basic capital gains exemption is created in new paragraph 38(a.4). The new provision will exempt individual and corporate donors from tax on the sale of private shares or real estate to an arm's length party if the proceeds are donated to a qualified donee within 30 days of the disposition. Where a portion of those proceeds is donated, the capital gains exemption would apply only to that portion. To be eligible, the donor must be resident in Canada and the requirements set out in new subsection 38.4(1) must be met. While paragraph 38(a.4)(i) provides requirements for donations of proceeds for *inter vivos* gift, paragraph 38(a.4)(ii) sets out rules for estate gifts where the disposition and gift is made by a taxpayer's graduated rate estate.[4]

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[2] http://www.carters.ca/pub/bulletin/charity/2015/chylb363.pdf.
[3] *Ibid* at 4-5.
[4] Graduated rate estate" is a new concept introduced in the 2014 Federal Budget that impacts estate gifts and administration of estates. See *Charity Law Bulletin* 359, "Implications of the New Estate Donation Rules Introduced by Budget 2014", February 25, 2015 at http://www.carters.ca/pub/bulletin/charity/2015/chylb359.pdf.

New section 38.3 provides complex formulas to determine the portion of a taxpayer's capital gain on the disposition that benefits from the exemption under paragraph 38(a.4). This section applies if the conditions in new subsection 38.4(1) are met. The new formula [A x (B – C)/D] will prorate the capital gains exemption to reflect the portion of the proceeds of disposition that are donated. The formula will also require the taxpayer to calculate the "eligible amount" of the gift (as defined in subsection 248(31) of the ITA) in order to determine the portion of the taxpayer's capital gain. This provision will ensure that the regular taxable capital gains inclusion rate in paragraph 38(a) is applied to the extent that the taxpayer's capital gain from the disposition of the property (during the donor's life time or in the context of death) exceeds the amount determined by the formula.

New section 38.4 provides detailed and complicated rules for the application of new paragraph 38(a.4) and anti-avoidance rules. Specifically, new subsection 38.4(1) provides a list of conditions that must be met in order to take advantage of the capital gains tax exemption under new paragraph 38(a.4). For example, the disposition must be a sale to a person or partnership; and the sale cannot be a transaction, or part of a series of transactions or events, that involves the circumvention of certain arm's length or non-affiliation requirements for the sale. The conditions also include anti-avoidance rules that will deny the exemption if certain events arise in the taxation year that the disposition of property occurs.[5]

If any of the three conditions set out in subsection 38.4(3) are met within 5 years of the disposition, then subsection 38.4(2) will apply to reverse and tax any capital gain that was previously exempted from tax in a prior year under paragraph 38(a.4). In general, these conditions address circumstances similar to those the anti-avoidance rules contained in new subsection 38.4(1) referred to above.

Subsection 38.4(4) contains additional anti-avoidance rules to address situations where a taxpayer who benefitted from preferential capital gains tax treatment under paragraph 38(a.4) has ceased to exist. Where the conditions in new subsection 38.4(4) are met, subsection 38.4(2) will effectively reverse a previous capital gains exemption by triggering a taxable capital gain in a later year. New subsection 38.4(5) will

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[5] Specifically, (a) the taxpayer, the qualified donee, or a person or partnership with which the particular taxpayer or qualified donee is not dealing at arm's length or is affiliated, acquires, directly or indirectly, all or any portion of the property; (b) share of a private corporation is redeemed, acquired or cancelled when the taxpayer, a person or partnership not dealings at arm's length with the taxpayer or the taxpayer's estate does not deal at arm's length or is affiliated with the corporation; and (c) the loanback rule in subsection 118.1(16) applies

charge interest in respect of the taxable portion of an amount deemed to be a capital gain under new subsection 38.4(2).

Subsection 40(12) allows an exemption from capital gains tax on donations of flow-through shares. This exemption is available to the extent that cumulative capital gains in respect of the dispositions exceed the original cost of the flow-through shares. Subsection 40(12) will be amended to ensure that it applies to disposition of flow-through shares that are issued by a private corporation, where the proceeds of disposition of the shares are the subject of a gift.

C. MEASURES TO ALLOW CHARITIES TO INVEST IN LIMITED PARTNERSHIPS

New subsection 253.1(2) will be introduced to provide that where a registered charity or RCAAA made or acquired an interest as a limited partner in a partnership after April 20, 2015, it will not be considered, solely because of that interest, to carry on any business or other activities of the partnership. The change will only apply if the charity or RCAAA is a limited partner; the charity or RCAAA deals at arm’s length with each general partner of the partnership; and the charity or RCAAA together with persons and partnerships with which it does not deal at arm’s length, does not hold interests in the partnership that have a fair market value of more than 20% of the fair market value of the interests of all partners.

This proposed change is in response to the charitable sector’s requests for clarity on the issue of whether registered charities, including private foundations, can invest in limited partnerships without risking their charitable status. CRA’s current position, relying on partnership law, is that charities that become limited partners in a limited partnership are carrying on a business rather than merely making a passive investment. This would therefore prohibit private foundations from making such investments because they cannot carry on any type of business under the ITA.

New subsection 149.1(11) of the ITA will also be introduced consequential to the introduction of new subsection 253.1(2) in relation to the ITA rules that apply to private foundations. Private foundations are subject to certain restrictions on their corporate shareholdings pursuant to sections 149.1, 149.2 and 188.1 of the ITA. In general, a private foundation is required to divest itself of excessive shareholdings in corporations and to disclose material corporate shareholdings in its annual information form. The effect of new subsection 149.1(11) is that the calculation of a private foundation’s excess corporate holdings will be determined by effectively looking through the partnerships of which it is member. Specifically,

each member of a partnership is deemed to own the portion of each property of the partnership equal to the proportion that the fair market value of the member's interest in the partnership is of the fair market value of all interests in the partnership. Subsection 149.1(11) is deemed to have come into force on April 21, 2015.

D. CONCLUSION

The application of these proposed rules will be far-reaching and it will no doubt take some time to determine all of the consequences flowing the new rules. The rules involve a complicated set of amendments to the ITA. As such, charities and donors would be well advised to seek advice from a qualified charity tax professional before deciding to move forward with a transaction based upon implementation of these new rules.

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