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Recent Changes to the *Income Tax Act* and Policies Relating to Charities and Charitable Gifts

(Power Point Presentation)

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A. SUMMARY OF ADDITIONS AND CHANGES TO CRA WEBSITE IN 2002 to 2004

- Refer to: www.ccra-adrc.gc.ca/tax/charities/menu-e.html for all CRA resource materials
- Changes to the CRA website cover the following topics:
 - Legislative Amendments
 - Circulars
 - Information Letters
 - Policy Statements
 - Fact Sheets
 - Bulletins
 - Brochures
 - Newsletters
 - Summary Policies
 - Consultation Papers

2

B. SELECTED DISCUSSION OF INCOME TAX AMENDMENTS AFFECTING CHARITIES

The Department of Finance issued 438 pages of Revised Draft Technical Amendments to the *Income Tax Act* on February 27, 2004. The major changes brought by the February 2004 Amendments, in addition to the December 20, 2002, February 18, 2003 Budget Amendments and the December 5, 2003 Amendments, are summarized below:

1. New Definition of Gift

- The traditional common law definition of a gift requires:
- The donor must have an intention to give
- There must be a transfer of property

3

- **The transfer must be made voluntarily without contractual obligation**
 - **No consideration or advantage can be received by the donor**
- **Therefore a contract to dispose of property to a charity at a price below fair market value would not generally be considered a gift at common law for which a charitable receipt could be issued for the difference in price**
- **Similarly, a gift to a charity that entitles the donor to receive a benefit of a material nature would not be a gift at common law for which a receipt could be issued even if the value of the gift significantly exceeded the benefit received**

4

- **Draft amendments to the *Income Tax Act* in December of 2002 and December of 2003 create a new concept of “gift” for tax purposes which permits a donor to receive a tax credit under the Act even though the donor receives a benefit, provided that the value of the property exceeds the benefit received by the donor**
- **However, the idea that a gift can provide a benefit back to the donor is foreign to the common law concept of a gift**
- **The draft amendments reflect an importation of the civil law concept of gift which permits a benefit back to the donor**

5

- **While a gift with an advantage may be deemed a gift under the *Income Tax Act*, it will not be a gift at common law and therefore there will be no transfer of title**
- **Utilizing a contract in order to transfer title may raise questions of donative intent that could preclude a gift for tax purposes**
- **In order to document the transfer of title where there is an advantage to the donor, and the expectation of a charitable receipt, the alternative of doing so by making use of a charitable trust should be considered**

6

2. New Split-Receipting Rules

- **The key requirements of what will be recognized as a gift for income tax purposes for split receipting based on the new definition of gift reflected in the December 2002 and December 2003 amendments are as follows:**
 - **There must be voluntary transfer of property with a clearly ascertainable value**
 - **Any advantage received by the donor must be clearly identified and its value ascertainable**

7

- **There must be a clear donative intent by the donor to benefit the charity**
- **Donative intent will generally be presumed provided that the fair market value of the advantage does not exceed 80% of the value of the gift**
- **The eligible amount of a gift will be the excess of the value of the property transferred over the amount of the advantage received by the donor**

8

- **The amount of the advantage is the total value of all property, services, compensation or other benefits to which the donor, or a person not dealing at arms length with the donor, has received or obtained or is entitled either immediately or in the future as partial consideration for or in gratitude for the gift or that is in any other way related to the gift**
- **Excluded from the value of the advantage is token consideration for the gift calculated on the basis of a “*de minimis* threshold” of the lesser of 10% of the value of the gift and \$75.00**

9

- **The charitable receipt will now need to identify the advantage and the amount of the advantage as well as the eligible amount of the resulting gift**
- **The advantage can be received prior to, at the same time as, or subsequent to the making of the gift**
- **It is not necessary for a causal relationship to exist between the making of the gift and the receiving of the advantage as long as they are “in any other way” related to each other**

10

- **Therefore, if a donor makes a gift in consideration of the charity employing his spouse, or the charity hires his spouse in gratitude of the gift being made in the future, then the value of the advantage would need to include the employment of the spouse**
- **In addition, the advantage could even be provided by third parties unbeknownst to the charity, which fact may necessitate that charities make inquiries of donors if they have received a related benefit from anyone**

11

- A receipt can be issued where the advantage received by the donor (less any token consideration based upon the “*de minimis* threshold” of the lesser of 10% of the value of the gift and \$75.00) does not exceed 80% of the value of the gift.
- For example, the ticket price for a table of 8 at a fundraising dinner is \$2,000.00, the fair market value of the dinner is \$800.00, the value of complimentary items; i.e., the door prizes and table gifts is \$300.00

12

Total price for a table of 8	\$2000.00
Less:	
- value of dinner	\$800.00
- complimentary items	<u>\$300.00</u>
(complimentary items exceed the lesser of 10% of \$2000.00 or \$75.00)	
Total value of advantage received by the donor	<u>\$1,100.00</u>
Eligible amount of charitable receipt	<u>\$ 900.00</u>

13

- **Split receipting at auctions**
 - **Generally, since the bid value at an auction is considered to be the fair market value, no charitable receipt can be issued for an auctioned item**
 - **However, when the value of an item can be clearly determined and is disclosed to all bidders in advance, the eligible amount for receipting would be the difference between the amount bid and the posted value**
 - **Where donative intent is established (i.e. in instances where the posted value of the item is not more than 80% of the accepted bid), a receipt may be issued for the eligible amount**

14

- **Purchases of service at auctions**
 - **Where a purchased service has an established fair market value that has been identified to all bidders at the auction before the opening bid, a receipt can be issued to the purchaser for the “eligible amount” where donative intent exists**
 - **The eligible amount for the value of the service would be the difference between the amount paid and the amount of the advantage**
 - **See Registered Charity Newsletter No. 17 at <http://www.ccradrc.gc.ca/E/pub/tg/charitiesnews-17/news17-e.html> for other examples of split receipting**

15

3. Charitable Annuities:

- **CRA indicated in Technical News No. 26 in December 2002 that the previous administrative position with regard to charitable annuities has no basis in law and cannot be continued as a consequence of the amendment to subsection 248(33) of the *Income Tax Act***
- **Instead, a new administrative policy has been proposed which provides for a charitable receipt based on the difference between the cost of the annuity and the gift, rather than the difference between the anticipated annuity payments and the amount of the gift**

16

Facts:

- **A donor makes a \$100,000 contribution to a charitable organization**
- **The donor's life expectancy is 8 years (and the donor lives 8 years)**
- **The donor is to be provided annuity payments of \$10,000 per year (total of \$80,000)**
- **The cost of the annuity to provide the \$80,000 payment over 8 years is \$50,000**

17

<u>Former tax treatment under IT-111R2</u>	<u>Proposed tax treatment under Technical News No. 26</u>
<ul style="list-style-type: none"> • the donor receives a tax receipt of \$20,000 for the year of donation, being the amount of \$100,000 in excess of the annuity payments of \$80,000 • All of the \$80,000 annuity payments are tax free 	<ul style="list-style-type: none"> • the donor receives a tax receipt of \$50,000 for the year of donation, being the amount of \$100,000 in excess of the \$50,000 cost to provide the annuity • \$30,000 of the \$80,000 annuity payments will be included as income of the donor over 8 years, with the balance of the \$50,000 to be tax free

18

<ul style="list-style-type: none"> • However, CRA indicated that the administrative policy set out in IT-111R2 will continue to apply to annuities that were issued prior to December 21, 2002. • The expectation of CRA that, notwithstanding the withdrawal of this administrative policy, “charitable annuities are likely to continue as a means of fund raising, and may well be more advantageous to the donor” remains to be seen

19

4. New Definition of Charitable Organizations and Public Foundations

- **In the December 2002 draft amendment, the definitions of charitable organizations and public foundations were amended by replacing the “contribution” test with a “control” test**
- **The rationale for amending the definitions is to permit charitable organizations and public foundations to receive large gifts from donors without concern that they may be deemed to be a private foundation**

20

- **The previous “contribution” test meant that where more than 50% of the capital of a charity was contributed from one donor or donor group then the charity would be deemed to be a private foundation subject to more stringent activity and disbursement requirements**
- **The new “control” test means that while a donor may donate more than 50% of the capital of a charity, the donor or donor group cannot exercise control directly or indirectly in any manner over the charity or be in a non arms length relationship with 50% or more of the directors or trustees of the charity**

21

- **As a result of the introduction of a “control” test, the convoluted business rules in relation to “control” will become applicable as a result of the phrase “controlled directly or indirectly in any manner whatever”**
- **Charities will now need to be careful that they do not unwittingly become designated as a private foundation instead of either a charitable organization or public foundation**

22

5. The Evolving Shutdown of Tax Shelter Donation Programs

Definition of Tax Shelter:

- **A tax shelter is defined under the *Income Tax Act* as any property for which a promotion represents that an investor can claim deductions or credits which equal or exceed the actual amount of the investment within four years of its purchase**
- **The definition of tax shelter was amended in the February 2003 Budget to include tax credits on charitable donations and limited recourse debt**
- **This meant that tax shelter donation programs with promises of net return on investments were required to be registered as tax shelters**

23

Description of Tax Shelter Donation Program:

- **The potential misuse of tax shelter donation programs continued to be scrutinized by CRA and was not limited to only “art flips”**
- **The position of CRA was set out in a CRA Fact Sheet entitled “Art-Donation Schemes or ‘Art-Flipping’”. The mechanism commonly utilized in these schemes is explained as follows:**
 - **Step 1: A promoter gives a person the opportunity to purchase one or more works of art or another item of speculative value at a relatively low price and works with the person in donating the items to a Canadian registered charity**

24

- **Step 2: The person donates the art or other item and receives a tax receipt from the charity that is based on an appraisal arranged by the promoter that is substantially higher than fair market value**
- **Step 3: When the person claims the receipt on his or her next tax return, it generates a tax saving that is higher than the amount paid**
- **These donation programs turn on the fact that the item in question is purchased at a substantially lower price than its much higher fair market value, and that a donation receipt is issued by a registered charity for the fair market value when the item is donated to it**

25

Warnings By CRA:

- **CRA provided warnings to charities considering becoming involved in donation tax shelters**
 - **CRA’s Fact Sheet entitled “Canada Customs and Revenue Agency Reminds Investors of Risks Associated with Tax Shelters” stated that registration as a tax shelter “does not indicate that the CRA guarantees an investment or authorizes any resulting tax benefits” and that “CRA uses this identification number later to identify unacceptable tax avoidance arrangements”**

26

- **CRA’s Fact Sheet concerning Art-Donation Schemes or ‘Art-Flipping’ indicated that third party penalty can include charities that receive the donation if “it knows – or if it can reasonably be expected to have known – that the appraised value were incorrect”**

December 2003 Amendment:

- **The December 5, 2003 draft amendments to the *Income Tax Act* are attempting to shut down tax shelter donation programs by severely restricting the tax benefits from donations made under tax shelter donation arrangements**

27

New Deeming Provision:

- **The proposed amendment deems the fair market value of property donated for the purpose of issuing charitable receipts to be the lesser of (i) the fair market value of the property and (ii) the cost (or the adjusted cost base where applicable) of the property to the tax-payer immediately before the gift is made in the following three situations:**

28

- 1) **If the tax-payer acquires the property through a “gifting arrangement” as defined in section 237.1 of the ITA, i.e. where it is represented that the acquisition of the property would generate any combination of tax credits or deduction that in total would equal or exceed the cost of acquiring the property in question, whether or not it was acquired within three years**
- 2) **If the tax-payer acquired the property less than three years before the gift was made**

29

3) If it was reasonable to conclude that when the tax-payer acquired the property, the tax-payer expected to make a gift of the property, but with the burden being on the donor to prove that the donor did not have an intention to make a gift when the property was acquired

- **The deeming provision does not apply to inventory, real property situated in Canada, certified cultural property, publicly traded shares and ecological gifts**

30

- **The deeming provision also does not apply to situations where the gift is made as a consequence of the donor's death**
- **The proposed December 5, 2003 amendments with regards to gifts of property, if passed, will apply to gifts made on or after December 5, 2003**

Limited Recourse Debt:

- **The December 5, 2003 draft amendments also preclude charitable receipts for limited recourse debt in respect of gifting arrangements**

31

- **Limited recourse debt is a form of tax shelter in which the tax-payer incurs a debt for which recourse is limited and which can reasonably be considered to be related to a charitable gifting arrangement**
- **Even in situations where the recourse is not limited, the debt may be deemed to be a limited recourse debt unless the arrangement in writing to repay the debt within 10 years and interest is paid annually within 60 days of the debtor’s taxation year at not less than CRA prescribed rate**
- **If a gift includes a limited recourse debt, then the amount of the loan would be deducted from the amount of the gift**

32

Substantive Gifts:

- **The February 2004 Amendments propose the insertion of a new subsection 248(38) that applies to gifts made after that date**
- **Subsection 248(38) is intended to prevent a donor from avoiding the application of the Deeming Provision by disposing of property to a charity and then donating the proceeds of disposition, rather than the donor donating the property directly to the charity**
- **The property disposed of by the donor is referred to as “substantive gift” and only applies to capital property and eligible capital property not already exempted under subsection 248(38)**

33

- **When a person disposes of property to a charity and donates the proceeds of disposition to either that charity or to another charity that does not deal at arm's length with the charity that purchased the property from the donor, then the property is referred to as a "substantive gift"**
- **Under those situations, the Deeming Provision in subsection 248(35) would apply and the fair market value is "deemed" to be the lesser of the fair market value of the substantive gift and the cost, or if the substantive gift is capital property of the tax-payer the adjusted cost base, of the substantive gift to the tax-payer immediately before disposition**

34

Anti-Avoidance Rule:

- **In addition to the deeming provision, the December 2003 amendments introduced an anti-avoidance rule in subsection 248 (37) that if one of the reasons for a series of transactions that includes a disposition or acquisition of property is to increase the amount of the FMV of the gift, then the cost of the property for receipting shall be deemed to be the lowest cost to the donor to acquire the property in question or "an identical property" at any time**

35

Practical Implications:

- **Charities will be required to inquire of donors of gift in kind when the property donated was acquired by the donors. Where possible, a written confirmation should be obtained from the donors to evidence the date of acquisition**
- **If the deeming provision applies, then the charity will need to inquire of the donor to determine the amount of the ACB of the gifted property, if applicable**
- **Charities may be required to inquire of donors of gifts in kind to determine whether the donors had an intention to make a gift at the time when the donor acquired the property**

36

- **Charities receiving gifts of private shares will need to determine if the shares were acquired within three years prior to the making of the gift or whether such shares had been exchanged for another class of shares i.e. in an estate freeze, either within three years or for the purpose of making a gift**
- **The proposed amendments in relation to limited recourse debt, if passed, will apply to gifts made on or after February 19, 2003**

37

Considerations for Charities Involved in Schemes

- **Where a charity has been involved in a tax shelter donation scheme prior to the announcement of proposed changes to the ITA provisions on December 5, 2003, the following are some of the issues that the charity will need to consider:**
 - **Tax shelter registration does not in itself give the donation program any protection**
 - **Possible difficulties in establishing fair market value of goods donated**
 - **The onus is on the charity to arrange a qualified appraisal of the donation, not on the promoter or the donor**
 - **Possible loss of charitable status**

38

- **It is important to determine whether the donations are gifts of capital or inventory**
- **Possible third party penalties may be levied against a charity for improper valuation of the fair market value of items donated**
- **Potential assessment challenges of donors by CRA with possible claims over against the charity and liability to directors**
- **Potential problems in complying with a charity's disbursement quota**
- **Due diligence requirements on the part of the charity in receiving, monitoring and disbursing products that were donated**

39

6. Revocation of Registration of Charities

- **Pursuant to the proposed December 2002 Amendments, subsection 149.1(2), (3) and (4) will be amended to permit the revocation of the charitable status if a charity “*makes a disbursement by way of a gift*” which is not a gift made “*in the course of charitable activities carried on by it*” or not a gift “*to a donee that is a qualified donee*” at the time of the gift**
- **All gifts made by a charity must be made in the course of furthering its charitable activities or transferred only to qualified donees**

40

7. Additional Qualified Donee

- **The February 27, 2004 Draft Amendments expand “qualified donees” to include a municipal or public body performing a function of government in Canada**
- **This amendment is in response to the Quebec Court of Appeal decision in *Tawich Development Corporation v. Deputy Minister of Revenue of Quebec*, 2001 D.T.C. 5144**

41

C. SELECTED DISCUSSION OF NEW POLICIES FROM CRA AFFECTING CHARITIES

1. New Policy Statement on Political Activities

- **The courts have held that an organization that has been established for a political purpose cannot be a registered charity. Political purposes have been defined by the courts as purposes seeking to:**
 - **Further the interests of a particular political party; or support a political party or candidate for public office;**
 - **Retain, oppose, or change the law, policy or decision of any level of government in Canada or a foreign country**

42

- **A charity’s ability to participate in political activities have been controversial and highly confusing for a long time**
- **CRA’s Policy Statement on Political Activities gives clarification to charities from a administrative, not legislative standpoint**
- **The Policy Statement gives a broader interpretation of what are charitable activities as opposed to political activities**
- **CRA has established three categories of involvement by charities in political activities:**
 - **Charitable activities**
 - **Prohibited activities**
 - **Permitted political activities**

43

- **Examples of charitable activities:**
 - **Distributing the charity’s research on a particular topic relevant to its charitable purpose**
 - **Releasing and distributing a research report to election candidates**
 - **Publishing a research report online**
- **Examples of prohibited activities:**
 - **Supporting an election candidate in the charity’s newsletter**
 - **Distributing pamphlets that underline the government’s lack of contribution to the charity’s goals**
 - **Preparing dinner for campaign organizers of a political party**
 - **Inviting competing election candidates to speak at separate events**

44

- **Examples of permitted political activities:**
 - **Buying a newspaper advertisement to pressure the government**
 - **Organizing a march to Parliament Hill**
 - **Organizing a conference to support the charity’s opinion**
- **Limits on using charitable resources for permitted political activities:**
 - **Under the ITA, a charity must devote substantially all of its resources to charitable activities**
 - **Substantially “all” is defined by the CRA as 90% or more, meaning that a charity may not devote more than 10% of its total resources per year to political activities**

45

- **Smaller charities with less than \$50,000 annual income can devote up to 20% of their resources to political activities; income between \$50,000 and \$100,000 can devote up to 15%, and income between \$100,000 and \$200,000 can devote up to 12%**
- **Resources used towards permitted political activities are not applied to meeting a charity's disbursement quota for receipted donations**

46

2. New Policy on Business Activities

- **Running a business is generally not a charitable activity**
- **However, a related business will be permitted subject to certain limitations**
- **A related business is defined as a business activity connected to a charity that is used in the furtherance of the charity's charitable purposes**
- **There are two kinds of related businesses:**
 - **Businesses that are linked to a charity's purpose and subordinate to that purpose, such as:**

47

- **A hospital's parking lots, cafeterias, and gift shops for the use of patients, visitors, and staff**
- **Gift shops and food outlets in art galleries or museums for the use of visitors**
- **Book stores, student residences, and dining halls at universities for the use of students and faculty**
- **Therefore, a church that operates a bible book store would likely be carrying on a permitted related business because the selling of bibles is related to the charitable purpose of the church**

48

- **Businesses that are run substantially by volunteers, i.e. 90% are volunteers, are deemed to be a related business even if the business is not linked to the charitable objects of the charity**
- **Unrelated business: Is a business activity that is neither related nor deemed related, i.e. if a church decides to buy and sell computers for profit, or run a catering business with paid employees.**
- **Charities cannot participate in unrelated businesses, as they risk being refused or losing charitable registration status**

49

3. CRA Policy on Ten Year Gifts

- **A ten-year gift is a donation that is made subject to a donor's written trust or direction that the gift be held by a registered charity for 10 years or more**
- **A ten-year gift is excluded from the disbursement quota**
- **However, when a 10-year gift is eventually spent, it must be included in calculating the disbursement quota**
- **CRA will need to clarify its position on what happens to inclusion in the disbursement quota when the ten year gift or a part of it is disbursed during the ten years**

50

4. New Policy on Donation of Gift Certificates

- **CRA has outlined a number of situations under which a charity may issue an official donation receipt for the donation of a gift certificate, including:**
 - **Where the donor purchases or obtains the gift certificate directly**
 - **Where the issuer of the gift certificate directly donates a gift certificate to the charity, and the charity, not a third party, redeems the certificate for property**

51

5. New Policy on Holding of Property for Charities

- **CRA has recognized that organizations that hold title for registered charities can be registered as charities themselves**
- **Charities may want to use charitable title-holding organizations in order to protect their assets from liability associated with operation**
- **Examples would be separate foundations for:**
 - **Land holdings**
 - **Equipment and/or management facilities**
 - **Licensing of Intellectual Property**

52

6. New Policy on Third Party Fundraisers

- **A charity can use a third party organization or fundraiser as an agent to organize a fundraising event**
- **However, the fundraiser, as agent, is responsible to the charity as principle and the charity is liable for the actions of the agent**
- **Therefore, a charity must retain control over all monies earned and all receipts issued in relation to a fundraising event**

53

7. Policy Commentary on Charities Managing Investment Portfolios

- **Clarifies whether or not a private foundation's management of an investment portfolio constitutes a business activity**
- **Private foundations are prohibited from involvement in any business activity**
- **However, managing one's own investment portfolio is not automatically considered a business activity, but a case-by-case analysis must be done**
- **The position of CRA is that registered charities can manage the investment portfolios of other registered charities at below market rates**

54

- **However this position does not address the problem of delegation and sub-delegation at common law**

8. Summary Policies

- **Examples of more than 200 Summary Policies affecting charities include:**
 - **Fundraiser**
 - **Religion**
 - **Broad & vague objects**
 - **Restricted funds**
 - **Confidentiality**
 - **Directors/trustees**
 - **Conditional gift**
 - **Designated gift**

55

D. OTHER NEW DEVELOPMENTS AFFECTING CHARITIES

- **Information returns submitted by charities are now available on-line, save and except for any portions of the return designated as confidential**
- **CRA will now automatically calculate the disbursement quota for a charity from the T3010**
- **The board of directors of a charity is advised to ensure the accuracy of reporting when completing the new shorter T3010A returns and to verify the records on-line to ensure that the information available to the public is correct**

56

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57